Inclusive Capitalism

How we can make independence work for everyone

David G. Green

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First Published October 2017

55 Tufton Street
London SW1P 3QL

email: books@civitas.org.uk

ISBN 978-1-906837-92-1

Independence: Civitas: Institute for the Study of Civil Society is a registered educational charity (No. 1085494) and a company limited by guarantee (No. 04023541). Civitas is financed from a variety of private sources to avoid over-reliance on any single or small group of donors.

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Typeset by
Typetechnique

Printed in Great Britain by
4edge Limited, Essex

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Preface

Soon our future will be back in our own hands. Our journey to independence gives us the chance to renew our vows as a free people and to look afresh at the problems we face and the opportunities we could seize. Whether we succeed or fail will depend in part on the public policies we pursue, especially those that have the potential to impair or enhance our spirit of enterprise. This book is a contribution to the debate about how we can make the most of Brexit. What economic policies are most likely to lead to prosperity for all, and what are the pitfalls to avoid?

David G. Green

Acknowledgements

I am very grateful to Michael Burrage, David Conway, Daniel Bentley, Anastasia de Waal and Catherine Green for reading earlier drafts and making invaluable comments. It goes without saying that they are not responsible for any remaining errors.

I am especially grateful to the Nigel Vinson Charitable Trust for its steadfast support of our work for many years now.

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Introduction

The main threat to the success of Brexit is that the government will be paralysed by a negative economic ideology that has been called market fundamentalism. Government is seen as always and everywhere the enemy of freedom, and our economic life is interpreted as a set of axiomatic relationships that can be understood only with the special insight of economists, who therefore think that their opinions should be followed. The 'four freedoms' of the EU are based on this ideology. They are really the four shibboleths of market fundamentalism. By demanding 'free movement' of four very different things – goods, services, money and people – economists treat them as if they are similar units of economic calculation. Goods and services are certainly produced in the expectation that they will be bought and sold, but money (capital) and people are not the same kind of thing at all. People, in particular, should never be treated as interchangeable units of production, but this is exactly what uncontrolled movement of labour achieves.

Applied to world trade, market fundamentalism has been called hyper-globalisation by Harvard economist Dani Rodrik. In similar vein, Larry Summers, also of Harvard and a former US Secretary of the Treasury, has argued that 'reflex internationalism' should give way to 'responsible nationalism'. I will argue that free-trade dogmatism has become a smokescreen for self-serving mercantilism, and that it has achieved the very opposite of the mutual benefit that reciprocal free trade under agreed international rules is capable of producing.

For all intellectuals who go into politics because they regard themselves as having superior insight, one of the main attractions of the EU is that when they come under pressure from voters they can offer the excuse that their hands are tied by EU regulations. In this manner, market fundamentalists rely on the EU's state-aid rules to prohibit government action in support of enterprise. In fact, enthusiasts for fundamentalism helped to write the state-aid rules to give themselves precisely this rationale for inaction. Human rights activists have a similar approach. They start with the assumption of their own intellectual and moral superiority and look for ways to undermine democracy, which they call populism or the tyranny of the majority. Human rights charters give them authoritative declarations that can be used to overrule democratic decisions and to impose their world view against the manifest wishes of the rank and file.

In a free society there are inevitably rival visions of where we should take our country. For many years it was common to identify the period from World War Two until the election of Thatcher and Reagan in 1979 and 1980 respectively as the era of collectivism. The Thatcher and Reagan administrations were seen to be 'rolling back' the frontiers of the state and renewing support for a market economy. In the USA and the UK these ideas became accepted across the political divide. Clinton embraced them in America and Blair and Brown have been called 'sons of Thatcher' and criticised for trying to be 'more free market than thou'.

There is no longer an intellectually coherent alternative to a market economy. The standard socialist analysis rejected private property in favour of government ownership; it claimed to renounce the profit motive in favour of the public service ethos; and renounced competition in favour of co-operation, mistakenly ignoring the fact that the opposite of competition is not co-operation but monopoly. If there is a rival to Western capitalism today it is the state capitalism of China and Russia, under which the dominant regimes allow space for some private initiative so long as it does not threaten the power of the rulers.

Western-style capitalism even with its faults is vastly superior, but it must simultaneously be admitted that the capitalism we experience today has some fundamental flaws that need to be overcome. The 2008 recession was a shock to the system. Countless books have been written questioning the underlying assumptions of the pre-2008 era, not least the idea that markets were self-correcting. Famously, one of the iconic leaders of that time, Alan Greenspan, conceded that his guiding beliefs had been wrong.

Nevertheless, support for market fundamentalism remains strong. Also called libertarianism, it is the idea that the fewer laws we have the more free we are. Typically such market fundamentalists advocate reducing the state to the bare minimum by cutting regulation, privatising, reducing taxes and curtailing welfare spending. Often, they accuse anyone who criticises any current business practices of 'business bashing'. But no less a commentator than Milton Friedman warned that defenders of a market economy should be careful not to become mere apologists for anything that businesses do.

Many have taken his advice and in recent years a powerful critique of market fundamentalism has developed among supporters of a market economy. Often they direct their criticism at 'crony capitalism', a term which draws attention to the way in which some corporations have distorted the law-making process to allow a small group to gain at the general expense. Very often self-serving groups have sailed under the flag of laissez faire or market fundamentalism, asserting that all government interference is bad, when often what they want is a different kind of intervention that benefits them. Others have criticised 'casino capitalism', a term which puts the spotlight on investments that are bets on whether the price of stocks, shares, currencies or commodities, will go up or down. Such gambling is contrasted with investment in productive assets – such as factories – in the expectation that they will create jobs and produce an income. Still others have compared 'financial capitalism' with 'producer capitalism', or 'predator capitalism' with 'producer capitalism'. The preferred alternatives have been called inclusive capitalism and real capitalism. I am going to advocate 'inclusive capitalism' and I am going to contrast it with 'naïve capitalism'. I use this more neutral term instead of crony capitalism or casino capitalism because the underlying problem is an intellectual mistake, rather than moral turpitude. There has been wrongdoing, some of it criminal, but the main challenge is to correct our mistakes.

Some defenders of capitalism hold fast to what they think is a pure, undiluted doctrine. In its most naïve form it asserts that a market is a natural condition found in the absence of government. In some cases their adherence to orthodoxy reflects an intellectual penchant for abstract, axiomatic reasoning, but in other cases it derives from a pragmatic argument that to concede that there are any faults in capitalism will create a slippery slope that will lead by degrees to complete defeat. But this doctrine falls into the trap of defending the indefensible and we have now reached a point in history when refusal to criticise 'naïve capitalism', despite its manifest deficiencies, is endangering support for the fundamental truths on which our prosperity and freedom are built.

These basic truths are that a market economy is the most effective way of increasing prosperity and providing an outlet for talent. Monopoly should be prevented and its opposite, competition, should be encouraged. The price mechanism should not be suppressed. Free pricing allows unforced mutual adjustment to changing consumer tastes, the availability of raw materials, and changing technical possibilities. Private property should be the norm because it promotes personal responsibility and enables us to resist the usurpation of political power. Individuals must be free to choose jobs, change jobs, select goods and services, and organisations should be able to be established and closed down as necessary.

I will suggest that we now face a choice between three political-economic systems: naïve capitalism, which prevails in Britain today; state capitalism, as found in China and Russia; and 'inclusive capitalism', an economic and political system compatible with democracy, personal freedom, international peace, and a market economy that is inclusive rather than extractive.

The system I am calling inclusive capitalism recognises that a market economy is not a natural outcome found in the absence of intervention by the state. Rather, it is an achievement of legislation and public policy. We need continuously to refine the laws and institutions of business and commerce. It is true that some interventions could undermine a market economy, but many are consistent with it, and the challenge we face is to identify these 'compatible interventions'.

Some will instinctively recoil from any idea of a national purpose because it implies a government directing the energies of its residents. But our national ideal has long been personal freedom by means of democratic self-government. In this view the government does not direct its residents, it protects our freedom to direct ourselves.

It is based on a view of the human condition that sees each of us as individuals within a national civilisation and as citizens of a political association. We are not abstract individuals with human rights divorced from any particular place or any specific human relationships. We have civil rights framed in co-operation with people with whom we share a land. Nor are we 'economic man', interchangeable units of labour subject to the laws of economics. We view our economic life as a voyage of discovery, which allows us to improve the human condition as we each believe best.

Our heritage of liberal democracy

The great philosopher of freedom, Michael Oakeshott, tried to put his finger on the fundamental truths that are worthy of defence. Our freedom, he said, rests on mutually supporting liberties none of which stands alone:

> 'It springs neither from the separation of church and state, nor from the rule of law, nor from private property, nor from parliamentary government, nor from the writ of habeas corpus, nor from the independence of the judiciary … but from what each signifies and represents, namely the absence from our society of overwhelming concentrations of power.'

In short, he says, we consider ourselves to be free because: 'no one in our society is allowed unlimited power – no leader, faction, party or "class", no majority, no government, church, corporation, trade or professional association or trade union. The secret of its freedom is that it is composed of a multitude of organisations in the constitution of the best of which is reproduced that diffusion of power which is characteristic of the whole.'[1]

I argue that we should champion inclusive capitalism because it represents European civilisation at its best. We share the ideal of free nations with many other European peoples and by our example we may encourage them to take back control of their own destiny from the empire builders and autocrats of Brussels. The centralisers dismiss the freedom struggles that are breaking out all over Europe as populism. But we now live in an age when the common people have a better understanding of what is precious about European civilisation than the condescending oligarchs who hold the reins of power.

In understanding European civilisation there is still much to be learnt from the approach taken by the French liberal, Francois Guizot, in a series of lectures delivered in the 1820s. He strongly influenced the great nineteenth-century defenders of liberty such as Tocqueville (who attended the lectures) and J.S. Mill (who in 1840 described Guizot as 'immeasurably the greatest public man living'). When judging the progress of our civilisation he asked two questions that should be considered together: what is the social and material condition of the people; and what is the internal life of the mind? He could envisage a society with a good standard of living and a fair system of justice, but in which intellectual life was stagnant. The higher ideal was a civilisation that was materially prosperous, in which justice prevailed, and whose citizens led a rich life of struggle to gain knowledge and understanding, to create things of beauty, and to distinguish right from wrong.[2]

For him the unit of analysis was not merely the government and the policies it was pursuing. Rather, it was the nation and its culture. The individuals who live in a national territory constitute the society – civil society. This society has a government – the state – which should be accountable to its citizens. The first task is always to defend personal liberty and to guard against the abuse of political power, but we must also cherish the social institutions, such as the family, that provide sustenance for every citizen as each develops the thinking and active qualities befitting a free people.

Europe has seen many struggles over the centuries and the distinctive quality of European civilisation has been its pluralism. There have been many battles for absolute dominance, across the continent and within nations. The spiritual power fought the temporal power; theocracy fought monarchy; aristocracy battled against democracy; and liberalism fought totalitarianism. But absolute power was not retained for long. The existence of independent nations and principalities allowed individuals persecuted by authoritarians to escape. In the eighteenth century Voltaire said that it was 'impossible for a writer who thinks freely, not to be persecuted in France'. He had already been imprisoned in the Bastille twice by the repressive *ancien régime*. He was first imprisoned in his twenties for criticising the Regent, the Duke of Orléans. There was no trial but he spent a year in prison at the Duke's pleasure. After a second clash with the authorities he came to live in England. Many other writers shared his fate but they were protected because Europe was divided between several nations and no one succeeded in tyrannising over the whole continent. As a result, Europe became the homeland of a civilisation that valued justice and prosperity for everyone alongside a rich life of the mind. As we leave the European Union we can see that its institutions are best seen as the most recent attempt to construct an autocratic powerbase. As always, our destiny as a people is to show by our example the true character of European civilisation.

Civil society and the state

Central to our national character has been the distinction between civil society and the state. We have a collective life as members of a free and democratic political association embracing everyone who lives in the UK. It can be seen as a free system because the primary aim of government is to enhance the individual freedom of citizens. In addition, the government itself is accountable to the electorate, which means we have the power to act collectively by deploying the machinery of the state without it becoming an entrenched dictatorship. It is not only that the government can be removed peacefully, office holders are also trustees for the common good.

In addition, we have a second collective life as custodians of our unique civilisation. Our mission as individuals, families and members of the numerous associations to which we belong is to uphold and transmit to the next generation a civilisation of which we can all be proud. Believing that our civilisation is worthy of our enthusiastic support does not mean turning a blind eye to the faults or shameful episodes in our history. One of the fundamental values to be transmitted is objectivity and a willingness to be self-critical.

It often takes a foreign observer to see the true character of a people and back in the 1920s a German academic, Wilhelm Dibelius, wrote a book whose aim was to explain to the Germans why the British people had defeated them in the First World War. He observed that, unlike Germans, the British people at their best did not need rulers to tell them what to do.[3] His insight remains valid. Much that is admirable in our way of life has been created by the voluntary actions of countless individuals in their own localities, and as we take back our independence we can expect numerous opportunities for invention and progress to be seized without anyone waiting for orders from Whitehall.

There has been much confusion about the nature of freedom and many still argue as if to be free is to face as few constraints as possible. Libertarians think that reducing the scope of law makes us more free, and the fewer laws the better. Locke explained why this claim was incorrect. In a 'state of nature' without law we had a right to protect ourselves against criminals, but private vengeance tended to be excessive. In civil society we could live under laws that applied equally to all and that were enforced justly by impartial judges. We gave up self-enforcement to live under just laws. To be free, in this view, is to live under laws designed to protect a realm of personal freedom.[4]

We have a strong tradition of distrusting political power. Any system of government can be captured by a few people who impose their own preferences on others or enrich themselves at the expense of other citizens.[5] The Brexit vote was a protest against this development in Europe.

It is now gradually dawning on the other free peoples of Europe that the EU is a utopian empire-building project that is trying to centralise power in a few hands without the consent of citizens. It is utopian because it is trying to centralise power without nation states, which are vital to the control of power and to the protection of rights. The prevalence of this attitude has been admitted by the president of the European Council, Donald Tusk. He told a conference of the European People's Party in 2016 that the EU was 'obsessed with the idea of instant and total integration' and had failed to notice that ordinary people did not share their enthusiasm for what he called 'A utopia of Europe without nation states'.[6] The eurozone is now seen, even by its supporters, as dysfunctional.[7] Utopian authoritarians want to steamroller through centralising measures to create a central agency with full control of fiscal and monetary policy in all member states.

The EU denounces nationalism and tries to associate nation states with fascism. But neither Hitler nor Mussolini were elected by an overall majority in an election. They were appointed by the head of state and then, once in power, prevented citizens from voting them out. The problem in both cases was not the presence of national sentiment as such but the abuse of national loyalty by authoritarian absolutists. In Britain, the Commonwealth countries, and the USA national allegiance was inseparable from democracy, and patriotic sentiment enjoined people to risk their lives for the freedom of others. Their nationalism won a victory for freedom and democracy over the rival nationalism of absolutism and authoritarianism.

The nation state is a political association for holding power to account

The single most important quality of a nation is that it is the best arrangement so far discovered for holding power to account. A free state allows for the peaceful transfer of power to an alternative government, when the rulers of the day no longer command the confidence of citizens.[8] Democratic accountability is exactly what the EU oligarchs do not want. EU institutions are designed to concentrate power in a few hands in Brussels. In the UK it is possible for the House of Commons to pass a vote of no confidence in the government, in which case an election must be held. The EU has no mechanism for triggering immediate elections. The European Parliament can pass a vote of no confidence in the Commission, which must resign, but there is no obligatory election. For example, in 1999 the Santer Commission resigned over a corruption scandal, fearing that it would be forced out by the European Parliament if it did not resign first. But there was no election, and five of the twenty commissioners were reappointed. Some of the same insiders were able to hold on to power and keep voters at arm's length.

Democracy is not just about the accountability of political office holders to the electorate but also about taking personal responsibility for the common good. It enjoins us all to ask what we can do for the good of fellow citizens. The EU is made up of donor nations and recipient nations and the aim of the latter is to take more out than they put in. No institution can last long if its members are thinking of how they can gain at the expense of the others. A democracy will only flourish if its citizens are guided by public spirit and civil courage.[9]

How the book is organised

Chapter 2 examines the idea that unfettered international trade – globalisation – will always lead to increased prosperity for everyone. Doubts about free trade have led to the renewal of support for the nation state, not only in Britain but also in some other European countries and in the USA. Sometimes criticism of globalisation and its impact is conducted as if we have to choose between free trade and protection but, as Chapter 2 argues, the loss of jobs in America and Europe has often been the result of what can only be called Chinese mercantilism, and not the unavoidable result of free competition.

I have referred to the tradition of market fundamentalism that contends that a market is a natural state of affairs that is to be found in the absence of government. All government is seen as interference with this 'natural' state. Chapter 2 discusses another interpretation of a market economy that is no less harmful. It is based on what Hayek calls 'scientism', which sees human economic behaviour as a system that can be explained by scientific laws and, therefore, rationally controlled by policy makers. Its arguments are deployed by both market fundamentalists and collectivists, which should in itself raise some doubts about its compatibility with a free society.

Others draw attention to mistakes in economic theory, most notably the 'efficient markets hypothesis' and the 'rational expectations hypothesis'. Anatole Kaletsky describes the rational expectations hypothesis as follows. To be scientifically valid all economic models had to assume that all economic actors had 'perfect knowledge of the laws of motion built into the economic model and to consistently use this knowledge to predict the future'.[10] The efficient markets hypothesis asserted that 'financial markets could never cause or amplify economic instability'. They would 'incorporate the best possible analysis of all available information'.[11] Everything of importance is said to be 'priced in'.

Naïve capitalism is the subject of Chapter 3. Many strong supporters of a market economy and a free society have criticised 'crony capitalism', a system that allows political power to be used by a small elite to extract wealth and avoid taking responsibility for their own mistakes. This view has been taken by a British Prime Minister. In her 'shared society' speech in January 2017 Theresa May said that people 'have seen a small minority in the banking and business sectors appearing to game the system and play by their own rules'.[12] But, it is not just a degenerate form of a market economy in which the rules are rigged, often the aim of lobbyists has been to weaken the essential, defining elements of a market economy. In some cases they sought rules that allowed them to gain financially while imposing any losses on the taxpayer. The most notorious example continues to be the way in which the big banks took reckless risks before 2008 because they (correctly) thought that taxpayers would rescue them if they lost money. The moral case for private property is that it creates the possibility of personal responsibility, but it is just such responsibility that some financial institutions wanted to escape. Moreover, they frequently had no commitment to the societies in which they made money, either as a civilisation or a political association. Allegiance was not in their vocabulary, even when the laws, systems of taxation, and schemes of rights and obligations were the indispensable precondition of their success.

We now face a choice between naïve capitalism and two main alternatives: state capitalism and what I am calling 'inclusive capitalism'. Some commentators have highlighted the similarities between the corporate insiders who benefit from the abuse of law making in America and the abuse of power in China. The difference, however, is that American cronyism through the USA's 'spoils system' can bolster the peaceful transfer of power, whereas the aim of the Chinese Government is to keep power in the hands of the Communist party. For this reason, Chinese capitalism is more accurately seen as state capitalism rather than crony capitalism.

State capitalism sees a market economy as a means to an end, namely upholding the power of the current political rulers. Since 1980 China has made rapid economic progress. In that year it contributed two per cent of world GDP but by 2016 the figure was 17 per cent. Over the same period America's share fell from 22 per cent to 16 per cent. The rise of China shows that a market economy can be made to serve dictatorship.

Inclusive capitalism is discussed in Chapter 4. It is patriotic and internationalist. It regards freedom as living under laws designed to uphold personal liberty. To be free is also to be able to act collectively by consent. Political power is not a licence to use force but to act as a trustee for the whole body of citizens. When the system works as it should, a new law is not merely an act of coercion but also a promise to be reasonable with each other. The market is kept in its place. It is not an ideal in itself but a method of wealth creation for the sake of higher ends, namely personal freedom and democracy.

Chapter 4 argues that we should stop assuming that unfettered free trade is always beneficial to everyone. We should ask whether other countries are trading for mutual benefit or for mercantilist advantage. When our companies try to compete against world prices, are they the result of a process of discovery or of mercantilism, namely the pursuit of national aggrandisement through trade? It argues that, when we encounter subsidies or mercantilism, we should make full use of WTO powers to take countervailing action.

Chapter 4 also describes interventions that are compatible with a market economy and asks how far it is legitimate to go in pursuing national prosperity. It contends that a measure of economic nationalism is justified so long as we use our wealth to equip ourselves to play a full part internationally in overcoming the great and continuing challenges – upholding peace and reducing poverty.

2

Globalisation, the market as a natural condition, and scientism

There is still strong support for laissez-faire doctrine. Many writers contend that a market is a natural state that would exist without government action, which is always therefore 'interference' with a pure natural condition. They believe that the smaller the government the more free we are. This idea of a natural state without law took hold because, when industrial society first emerged in England, it did so in a society governed largely by common law rather than statute law. As a result, some people appear to have mistakenly assumed that there was no law. It is easy to see how this happened. During the industrial revolution new factories were established outside the boroughs where the guilds were in control. They were escaping from local regulation but not from all law.

The common law continuously protected individual rights. In a famous case in the early days of industrialisation the Chief Justice of the Common Pleas, Lord Camden, ruled on the right to be free from government searches. The court held that the government did not have the power to enter and search private premises. The ruling idea was that the government only had the powers granted by common law or statute. We were free to do anything not prohibited by law and the government could only do what the law permitted.

The case concerned three bailiffs who had searched the home of John Entick in 1762 and took away some of his papers. They said that a warrant for the search had been lawfully issued. Lord Camden, ruled that 'if this is law it would be found in our books, but no such law ever existed in this country; our law holds the property of every man so sacred, that no man can set his foot upon his neighbour's close without his leave.'[1]

Individuals were secure in their property because the common law was enforced by the courts. The conclusion that the government had no legal power to act is not the same as finding that there was no law at all. There was a legally protected realm of freedom. The ruling of the court was an example of the law as a device for the protection of individual liberty. The state provided independent institutions – the courts – that actively protected individuals from force or crime, including from the government itself. The realm of free initiative thus created is protected by law. It is not due to the absence of law.

The idea that freedom depended on the absence of law was reinforced by the work of the early liberal reformers. The philosophical radicals of the late eighteenth and early nineteenth centuries, such as Bentham, were law reformers. They sought to sweep away laws unsuited to the new ways of earning a living that were developing. Often old laws were simply abolished which gave the impression that nothing was put in its place, but every transaction in the industrial revolution continued to be governed by law. Blackstone had published his *Commentaries on the Laws of England* in the 1760s, revealing the vast scope of the law. It covered the value of money, property ownership, contracts, taxes, companies, licences, weights and measures, as well as buying and selling. England was without doubt a law-created realm of freedom.

The properties of markets were easier to discern in earlier times when markets and hiring fairs tended to be confined to a physical location. In such cases the rules were enforced by local courts of 'piepowder' with jurisdiction over buyers and sellers. Commodities and stock exchanges too were organised by groups of traders who owned the physical location and enforced the rules. Exchanges continue to be regulated in great detail, with machinery for settling disputes and enforcement of obligations. Dealers had an interest in selling to more people and an exchange could enforce discipline by withholding the ability to trade. It is not without significance, said Nobel prize-winning economist Ronald Coase, that these exchanges – often used by economists as examples of a perfect market and perfect competition – are 'markets in which transactions are highly regulated'. It suggests that 'for anything approaching perfect competition to exist, an intricate system of rules and regulations would normally be needed'.[2]

Nevertheless the opposite view continues to be taken for granted in many media discussions. Columnists in the *Daily Telegraph* habitually take for granted the merits of market fundamentalism. Very typical is Matthew Lynn, a regular columnist for the *Daily Telegraph*, who wrote in July 2016: 'After ensuring property rights, and the rule of law, and lowering tariff barriers, there is remarkably little the state can do that makes much difference to business one way or the other. Everyone should just stop worrying about it.'[3]

The defenders of naïve capitalism

Non-interventionism often leads to the argument that we should scrap all tariffs. And after independence, some economists have argued that the UK should abolish all tariffs unilaterally. They acknowledge that there will be job losses but argue that we will all be better off eventually. Their reasoning is based on the belief that a market economy leads to the efficient allocation of labour and capital so long as the government does not interfere. In February 2017, Economists for Free Trade advocated a policy of unilateral zero tariffs. Summarising their reasoning, Professor Patrick Minford said that the rival view, which he called mercantilism, ignored:

> 'the way in which trade rearranged itself in the long term, given that world trade is highly competitive and goods are priced to make world supply and demand equal. No one country can influence this world price by its tariffs: the effect on world demand is zero or trivial because all it does is reduce demand for, say, corn, from foreign suppliers and switch it to home suppliers. But the total demand for corn worldwide is the same! So the world price is the same and all that happens is home prices are raised by the tariff. This rise in home prices makes consumers worse off, and causes resources to flow into the protected industry, and away from other industries where they would be better used. This is indeed self-harm.'[4]

Economists for Free Trade believes that the UK should unilaterally scrap the external tariffs that now apply to imports because of our EU membership. We should aim to buy goods in the cheapest markets. Because some industries are protected by the EU's common external tariff, then industries such as the car industry, which has a 10 per cent tariff, will be unable to survive: 'Leaving the EU and eliminating this protection would, according to these figures, raise service output and effectively eliminate manufacturing in the long run'. This destruction of thousands of well-paid jobs, argues Professor Minford, 'should not be regarded as very shocking' because manufacturing has been declining anyway.[5]

Similar reasoning has been used to justify permitting the collapse of the steel industry. When asked whether the Government should allow the steel industry to be closed down, Sam Bowman of the Adam Smith Institute told Bloomberg in 2016: 'If we bail out industries that are unprofitable in the long term, we're locking capital and labour into unproductive work. If you bail out these firms, where do you stop? Basically you'd have given up on capitalism.'[6]

Allister Heath, deputy editor of the *Daily Telegraph*, has been no less blunt:

> '… allowing the market to determine the allocation of capital works; trying to "save jobs", pick winners, engage in favouritism or buck reality doesn't work. Officials cannot know in advance if one or other company will make a better steward for corporate assets; and even so-called "asset strippers" actually create economic value by reallocating resources and making sure that hidden value is extracted.'[7]

This economic orthodoxy is combined with a utopian theory that holds out the promise of a remote future which will be much better for everyone: the 'long run'.

But, what if the world prices of which Professor Minford speaks are not market prices? What if people displaced do not become better off in the long run? And what if the market does not allocate labour and capital efficiently?

When world prices are not market prices

Free trade is defended because it can be mutually beneficial but, rather like toleration, it only works if everyone plays by the same rules. Toleration of aggressively intolerant groups gives them an advantage. In the same way, free trade only makes everyone eventually better off if all parties are looking for mutual benefits. The outcome will not be beneficial to everyone if one nation treats trade as a kind of substitute for war and aims to gain advantage at the expense of others in order to achieve economic and military superiority. Historically this attitude was called mercantilism, and it is the strategy of China today.

The most striking development in the last few years has been the rise of China from about two per cent of world GDP in the 1970s to about 17 per cent today.[8] It was achieved not by being the most efficient producer of goods but, especially after 1994, by currency manipulation and by selectively ignoring the rules of the World Trade Organisation after joining in 2001. China continues to act in a mercantilist spirit, that is, it regards trade as a way of gaining supremacy over other nations, not as a process of mutually beneficial exchange. The result has been, not only that rich countries have lost jobs to China (as described below), but also the low-wage economies.

Economists argue that prosperity comes from a combination of specialisation followed by trade between independent buyers and sellers. They claim the same for international specialisation and trade, but often forget the preconditions for their model to work. Companies must be genuinely independent, which means they have to make ends meet and so must be efficient to survive. Competition between independent companies encourages a search for efficiency, but companies propped up by government subsidies face no such pressure to be efficient.

Some argue that world prices are the measure of efficiency but often world prices are not market prices, and this is especially true of Chinese export prices. Many Chinese companies do not operate under the conditions assumed by the naïve model of capitalism.

China prevents the free negotiation of wages; indeed it represses trade unions. Its companies do not meet international accounting standards, which are designed to promote transparency. It subsidises exports, contrary to WTO rules, and it imposes import tariffs contrary to WTO rules. It has weak environmental regulations, thus reducing its costs. It also has weak health and safety laws that, despite their inadequacy, are frequently not enforced. It has state-owned companies and state-owned banks that provide undisclosed subsidies. Its government offers land to companies at low undisclosed rents.

Some companies are nominally private, but there is no genuine private ownership in China; there is state authorised discretion. The paramount aim of the system is to keep power in the hands of the Communist party. Companies typically require a political patron to survive.[9] There are no checks and balances. This is the exact opposite of America, where private wealth can empower opposition to the government of the day. For example, Jeff Bezos, the founder of Amazon, recently bought the *Washington Post* newspaper, which was used to campaign against Donald Trump. If he had tried to do the same thing in China he would be lucky still to be alive. Jack Ma, the owner of Alibaba, which is similar to Amazon, bought the English-language *South China Morning Post* in 2016. However, there is not the slightest chance in China of building up a media group to criticise the government, let alone to create a viable government in waiting. It's true that money can be used in America to cajole public opinion and 'buy' votes, but not just for one party. In America, wealth upholds freedom and democracy. Private wealth can challenge the holders of political power, without fear. China is not a free society. The more economically powerful it gets, the more it threatens the free world.

China has often manipulated its currency by forcing exporters to save their US dollars in the form of Chinese Government bonds denominated in dollars. The dollars have been used to buy US Treasury bonds and other US assets, thus keeping the exchange rate of the dollar higher than if the dollars had been used to buy yuan. Under pressure from the US Congress China has become a little less blatant about its mercantilism and the Trump administration appears to have decided to take no further action because it needs China's support to control the nuclear threat from North Korea. This approach may be 'realpolitik' but it does not alter the underlying reality that China is seeking to gain at the expense of other nations.

Currency manipulation is a longstanding problem. Keynes warned of the dangers during the long negotiations leading up to the Bretton Woods agreement at the end of World War Two, but his warnings were ignored. Indeed, the great failure of the Bretton Woods discussions was to deal with persistent large trading surpluses. WTO rules allow for countervailing measures against dumping and subsidies, and International Monetary Fund (IMF) rules oppose currency manipulation. But both the WTO and the IMF expect nations to take action. There is no central enforcement machinery (nor should there be), and the result has been that self-serving mercantilist nations have profited at the expense of others for long periods.

In the 1980s Japan was seen as a threat to American jobs, much as China is today. President Reagan introduced voluntary import restraints for Japan in 1981 and argued that the agreement would give American workers a chance to compete. In 1985, under the Plaza Accord, measures were taken to end Japanese currency manipulation and force up the price of the yen. Similar action against China is justified but currently seems unlikely.

To summarise: sometimes world prices are market prices and sometimes they are not. Often they are prices manipulated by mercantilist governments. Specialisation and trade has often proved to be a very effective way of increasing prosperity and spreading it to other parts of the world. But shared prosperity is only the outcome if trade is conducted with mutual advantage in mind. If it is conducted in a mercantilist spirit there will be winners and losers and, if it is conducted under the control of a government aiming to increase its wealth and military power at the expense of others, there could be long-term hardship. China is the striking example today. Market outcomes have not been the result of a search by independent producers to find the best way of meeting the needs of consumers or the most efficient method of production. Exports have been subsidised by an authoritarian dictatorship.[10]

What if displaced workers do not become better off in the long run?

Some economists acknowledge that there will be job losses in the short run but argue that we will all be better off eventually. And yet often the result is long-term loss. The underlying mistake is the belief that the abstract model of the economy – perfect competition – describes reality. Economists know about market failures and that some people lose out in the short run, but they cling to the belief that everyone will be better off eventually. What if 'eventually' takes ten years or longer to arrive during a working life of 40 years? Individuals will suffer a permanent loss of lifetime earnings. What if many people in some countries are poor for decades?

The international division of labour and free trade have often not made everyone better off. Let me begin with an anecdote to highlight the human consequences, before summarising the academic research. In 2017 the tyre manufacturer Goodyear moved from a factory in Wolverhampton to Mexico and Lord O'Neill interviewed displaced workers for a BBC documentary. One worker, aged 54, had lost a job that paid £34,000 and could only get work packing yoghurt that paid £20,000. According to economic theory, he should have moved 'up the value chain' and be on a higher wage. This is how the theory is described by Professor Minford in the context of leaving the EU:

> 'The EU single market is highly protectionist ... This protectionism raises the prices of both food and manufactures by around 20 per cent to UK consumers, implying an 8 per cent rise in their overall cost of living. While this is nice for farmers and manufacturing firms, who make higher profits, the losses of consumers are far greater. When we leave the EU, protected prices will be replaced by world prices. This generates healthy competition which pushes up productivity, forcing firms to go "up the value chain" towards more hi-tech methods.'[11]

This prediction of greater prosperity in the long run is properly called utopian in that it focuses on a remote benefit as a justification for current hardship. However, we now have scholarly studies of the claims that members of nations that are open to trade are always better off. A study by Daron Acemoglu of the Massachusetts Institute of Technology (MIT) and others concluded that trade with China caused significant job losses in the USA between 1999 and 2011. Counting direct and consequential job losses they estimated that about 985,000 jobs were lost in manufacturing and 1.98 million in the whole economy. They also tried to assess the overall impact on localities by studying 'commuting zones' and estimated that total job losses between 1999 and 2011 had been closer to 2.37 million.[12]

Three of the authors of the above study examined job losses in local areas more closely. David Autor (MIT), David Dorn (University of Zurich) and Gordon Hanson (University of California) found that adjustments to the 'China shock' in local labour markets were very slow, with wages depressed and employment still reduced a decade later. Exposed workers experienced great job churning and reduced lifetime earnings. Offsetting employment and wages gains elsewhere in the USA had not materialised.[13]

A study of the UK by J.P. Pessoa of the Centre for Economic Performance at the London School of Economics found similar results. Analysing the period between 2000 (the year before China joined the WTO) and 2007 (the year before the 'great recession') support was found for three propositions: (1) An increase in Chinese import competition in an industry led to a decrease in earnings; (2) An increase in imports from China led to an increase in the number of years workers spent out of employment; and (3) Chinese import competition had a stronger impact on low-paid workers.[14]

Some economists emphasise the role of automation in reducing manufacturing jobs, and it has undoubtedly been a major factor.[15] Within the USA, jobs have also moved from northern states to southern states such as Alabama, which is now a major centre for vehicle manufacture. But these developments do not contradict the claim that jobs have been lost to China, they merely supplement it.

These findings are consistent with earlier investigations that discovered a link between openness to trade and the growth of the welfare state. The reality of growing international trade is that, as trade has increased as a proportion of world GDP, the more the welfare states of nations have needed to grow to protect the casualties. In other words, free trade has paradoxically led to bigger government chiefly because it takes a long while for adjustments to be made in the jobs market. Dani Rodrik of Harvard University has found that: 'There is a positive and robust partial correlation between openness, as measured by the share of trade in GDP, and the scope of government, as measured by the share of government expenditure in GDP.' Societies, he concluded, 'seem to demand (and receive) an expanded government role as the price for accepting larger doses of external risk. In other words, government spending appears to provide social insurance in economies subject to external shocks.'[16]

The greater the amount of market exchange, the more powerful the government needs to be. The more exposed a nation is to trade, the more social insurance is needed. According to Rodrik, the welfare state is the flip side of an open economy.[17]

To sum up: displaced workers do not always move 'up the value chain' to become better off. Often they remain on welfare for long periods or on low wages.

To add insult to injury, economic utopianism often goes hand in hand with a version of Social Darwinism, which allows losers to be treated with scorn, or in American terminology, denounced as trailer trash. If they have not 'gone up the value chain' it must have been their own fault. They deserve to have lost their jobs because they can't compete with overseas workers.

A slightly less harsh but no less unsympathetic attitude is the tendency of some economists to attack victims of mercantilism for being selfish. They are seen as a group demanding protection that leads to higher prices for other consumers. Their natural resentment at being blamed for a predicament that is not of their own making partly explains why many people in the US rust belt voted for Donald

Trump, despite his personal failings. They have legitimate complaints and he spoke up for them.

Paul Samuelson, perhaps one of the best-known economists, recognised that not everyone benefited from free trade and cited the Stolper-Samuelson theorem. Unskilled workers in a high-wage economy like the USA face competition from unskilled labour in low-wage economies, because the latter are 'close substitutes' for the former. The 19th edition of his textbook (co-authored with William Nordhaus after Samuelson's death in 2009) accepts that unskilled workers in high-income countries have suffered reductions in real wages in the 30 years up to 2010 because of the increased importing of goods from low-wage countries. But 'the theory of comparative advantage shows that other sectors will gain more than the injured sectors will lose. Moreover, over long periods of time, those displaced from low-wage sectors eventually gravitate to higher-wage jobs.' People who are 'temporarily injured' by international trade are 'genuinely harmed' and become 'vocal advocates for protection and trade barriers'.[18]

Should they be helped? The authors think not. According to the theory of comparative advantage 'an industry which cannot compete with foreign firms ought to be injured by imports'. They admit that this 'sounds ruthless' but contend that industries that can't compete deserve to be 'killed off'.[19]

Anyone who has done a bit of reading about international trade will have encountered the concept of comparative advantage. Some economists seem to think it is a kind of iron law. Paul Samuelson, for example, says that 'this simple principle provides the unshakeable basis for international trade'.[20] The principle of comparative advantage, he says, 'holds that each country will benefit if it specializes in the production and export of those goods that it can produce at relatively low cost. Conversely, each country will benefit if it imports those goods which it produces at relatively high cost.'[21]

He and other economists feel rather superior about this insight because it 'goes beyond common sense'. A country can benefit from free trade even if it is 'absolutely less efficient' or 'absolutely more efficient' than other countries in the production of every good.[22]

As always, David Ricardo is cited as the originator of the insight that you do not have to be the absolute best at making something to be a useful trading partner. Ricardo used the examples of wine and cloth as traded between Portugal and England and argued that, even if it were cheaper (measured in hours of labour) to produce both wine and cloth in Portugal than in England, it would be more advantageous for Portugal to specialise in wine because its production used fewer hours of labour than cloth making.

In *On the Principles of Political Economy and Taxation* Ricardo explained why it would pay people in Portugal to make more wine and less cloth, which they could buy from England. England could produce a given quantity of cloth with the labour of 100 men for a year and a given quantity of wine for 120 men. Cloth could be produced in Portugal for the labour of 90 men in a year and wine for the work of 80 men. He concluded that it would be better to use Portuguese capital for wine making because she can gain more than by using the same capital for cloth making:

> 'To produce the wine in Portugal, might require only the labour of 80 men for one year, and to produce the cloth in the same country, might require the labour of 90 men for the same time. It would therefore be advantageous for her to export wine in exchange for cloth. This exchange might even

> take place, notwithstanding that the commodity imported by Portugal could be produced there with less labour than in England. Though she could make the cloth with the labour of 90 men, she would import it from a country where it required the labour of 100 men to produce it, because it would be advantageous to her rather to employ her capital in the production of wine, for which she would obtain more cloth from England, than she could produce by diverting a portion of her capital from the cultivation of vines to the manufacture of cloth.'[23]

Ricardo also discussed the implications for owners of capital in England. If the only consideration were to produce cloth at the lowest possible cost, then the investment capital of England would move to Portugal:

> 'It would undoubtedly be advantageous to the capitalists of England, and to the consumers in both countries, that under such circumstances, the wine and the cloth should both be made in Portugal, and therefore that the capital and labour of England employed in making cloth, should be removed to Portugal for that purpose.'[24]

However, Ricardo recognised that investors may choose lower profits in their homeland because its government has objectives they value, and not least because they regard the law as more just and more certain:

> 'Experience, however, shews, that the fancied or real insecurity of capital, when not under the immediate control of its owner, together with the natural disinclination which every man has to quit the country of his birth and connexions, and intrust himself with all his habits fixed, to a strange government and new laws, check the emigration of capital.'[25]

Ricardo ventured the opinion that he would not want to see such sentiment diminished, even though cloth makers in

England would earn lower profits than in Portugal:

> 'These feelings, which I should be sorry to see weakened, induce most men of property to be satisfied with a low rate of profits in their own country, rather than seek a more advantageous employment for their wealth in foreign nations.'[26]

Adam Smith had made a similar point when discussing tariffs and import restrictions:

> 'First, every individual endeavours to employ his capital as near home as he can, and consequently as much as he can in the support of domestick industry; provided always that he can thereby obtain the ordinary, or not a great deal less than the ordinary profits of stock.'

This was because:

> 'In the home-trade his capital is never so long out of his sight as it frequently is in the foreign trade of consumption. He can know better the character and situation of the persons whom he trusts, and if he should happen to be deceived, he knows better the laws of the country from which he must seek redress. In the carrying trade, the capital of the merchant is, as it were, divided between two foreign countries, and no part of it is ever necessarily brought home, or placed under his own immediate view and command.'[27]

Smith therefore argued against many (but by no means all) import tariffs and prohibitions arguing that so long as investors could make 'the ordinary, or not a great deal less than the ordinary profits of stock' they would tend naturally to invest in their country of residence, which did not therefore need any special protection.[28]

There is a subtlety and an essential human sympathy in the reasoning of Smith and Ricardo, which is wholly absent from the axiomatic writing of Samuelson and Minford.

An even more fundamental objection to the theory of comparative advantage as the criterion for investment has been revealed by an analysis of the huge database of cross-country trade held at Harvard University. If the theory of comparative advantage were true, then the wealthiest countries would be the most specialised. In fact, the wealthiest countries are economically the most diversified.

The Atlas of Economic Complexity developed two measures, which were called ubiquity and diversity. Ubiquity is the name for the number of countries that make a product and diversity is the name for the number of products exported by any given nation. The index of complexity combines the two measures. If prosperity results from specialisation, then prosperous countries would score low on ubiquity and diversity. But prosperous nations had higher scores for diversity. Germany, for example, had a low score for ubiquity of key exports but a high score for diversity. That is, it does export some goods that few other countries can produce (such as nuclear reactors and boilers) but also exports a wide range of goods that could have been imported.

Why is there a link to diversity? Because the number of products made in a country or region makes it easier to develop new capabilities. Professor Keen, who analyses the index of complexity, gives the example of a nation that makes sails for yachts and also surfboards. It is much easier to develop a new product, such as a sailboard, when the knowledge and skills are already available locally.[29] Countries with a wide range of capabilities are, therefore, better able to adapt and change over time. Economists have tended to over-value specialisation as the route to prosperity, and to underrate the capacity for rapid adaptation that is made possible by the production of a wide range of products.

What if the market does not allocate resources efficiently?

Chapter 3 shows how some of the main actors are not even trying to allocate labour and capital efficiently. They trade for immediate gain; they do not even invest in productive assets. This chapter focuses on international trade. Even when a Communist dictatorship sells products to the West at below cost, some writers speak of the efficient allocation of labour and capital. But in China, the ruling Communist party only permits the allocation of labour and capital that helps to keep power in its own hands.[30]

We can't separate a market economy from its political context. The most fundamental question is always whether it enhances or undermines freedom and democracy. We should not allow economic positivists to get away with portraying economic theory as a scientific discipline that accurately describes economic activity.

As Adam Smith pointed out, specialisation and the division of labour allow output per hour of work to be much higher, and trade allows us to share this prosperity with others. However, once we are mutually reliant, changes in consumer tastes, the availability of raw materials and the cost of production in remote places all have rebound effects throughout the world. A market economy allows us to adapt to these changes and can be seen as a discovery procedure (in Hayek's terminology) in which we learn to adjust as we go along.

But this is not the view propagated by economic positivists. They describe a system which they say is self-adjusting and leads to equilibrium. Professor Minford calls his approach a computable general equilibrium

(CGE) model. The relationships in the CGE model 'are numerical so that we can extract meaningful estimates of the quantitative effects of changing trade policies in the long run'. He concedes that we cannot aspire to any 'exact realism'[31] but insists that effects can be usefully quantified.

The highest priority is given to low prices. Any argument against his conclusions is dismissed as the result of ignorance or a vested interest.[32] In an online publication dated March 2016, Professor Minford assumes that the UK trades 'in a competitive world market, where world prices for these goods are set by world supply and demand'. The UK has only 3 per cent of world GDP and is consequently a 'price-taker', 'that is whatever it sells or buys on the world market has no effect on the world price'.[33] Moreover, capital is 'traded around the world and is mobile, with a price set in world markets'.[34]

He admits that his argument is 'pure theory', which means 'there will be numerous ways in which actual markets differ in detailed effects'. However, even if there are some detailed differences in practice they are 'likely to be of second order':

> 'The force of the point lies in looking at "general equilibrium" (i.e. all markets when all effects have worked out), rather than at one market on its own, "partial equilibrium", where the effects may be strong but quite misleading for the overall effect. Unfortunately many policy commentators are ignorant of this general equilibrium analysis.'[35]

Professor Minford appears to believe that his model can capture everything that really matters ('when all effects have been worked out') but he seems unaware that this is the attitude that Hayek calls the 'fatal conceit'. Moreover, Hayek has long criticised economists for exaggerating what they know. When he accepted the Nobel Prize for economic science in 1974, Hayek's lecture repeated the severe criticism of economic theory he had first voiced in 1942. He argued that economics as a profession had 'made a mess of things':

> 'It seems to me that this failure of the economists to guide policy more successfully is closely connected with their propensity to imitate as closely as possible the procedures of the brilliantly successful physical sciences – an attempt which in our field may lead to outright error. It is an approach which has come to be described as the "scientistic" attitude – an attitude which, as I defined it some thirty years ago, "is decidedly unscientific in the true sense of the word, since it involves a mechanical and uncritical application of habits of thought to fields different from those in which they have been formed".'[36]

He continued:

> 'We know: of course, with regard to the market and similar social structures, a great many facts which we cannot measure and on which indeed we have only some very imprecise and general information. And because the effects of these facts in any particular instance cannot be confirmed by quantitative evidence, they are simply disregarded by those sworn to admit only what they regard as scientific evidence: they thereupon happily proceed on the fiction that the factors which they can measure are the only ones that are relevant.'

He uses the example of demand-management policies intended to increase employment:

> 'The correlation between aggregate demand and total employment, for instance, may only be approximate, but as it is the only one on which we have quantitative data, it is accepted as the only causal connection that counts. On this standard there may thus well exist better "scientific"

> evidence for a false theory, which will be accepted because it is more "scientific", than for a valid explanation, which is rejected because there is no sufficient quantitative evidence for it.'[37]

This was no purely theoretical observation. He began his 1974 lecture by arguing that the accelerating inflation then being experienced 'had been brought about by policies which the majority of economists recommended and even urged governments to pursue'. Their focus on aggregates, such as average prices and unemployment, that could be measured distracted them from other valid explanations for rising prices, including the productivity of individual enterprises.

Later, in 1988, in *The Fatal Conceit* he says that some economists come close to using 'magic':

> '…because of the delusion that macro-economics is both viable and useful (a delusion encouraged by its extensive use of mathematics, which must always impress politicians lacking any mathematical education, and which is really the nearest thing to the practice of magic that occurs among professional economists)'.

Such economic phenomena as value and prices are explained as 'objective' occurrences independent of human knowledge and aims, when such explanations 'cannot interpret the function or appreciate the indispensability of trading and markets for coordinating the productive efforts of large numbers of people.'[38]

He is not the only Nobel Prize winning economist to challenge the tendency of economists to exaggerate what they know. Professor James Buchanan won the Nobel Prize in economic science in 1986. In 1997 he wrote an essay entitled 'Has economics lost its way?' in which he responded to criticisms of economics that were increasingly being voiced by other economists.[39]

Buchanan accepted the founding assumptions of economic thought, namely that people seek to better their conditions and that they take part in mutually beneficial trade to improve their lives. He argued that from these foundations it was possible to frame falsifiable propositions, which therefore made economics a science. But, he emphasised that people try to improve their lives according to their own evaluations of betterment. This brings into existence value that does not exist independently. Such exchange value is only discovered in markets.

Here, he said, was the 'wrong turn' of economics. Value is presumed to exist independently of market evaluation in an exchange. The values of goods and services were presumed to exist 'out there' when they do not.

Hayek had criticised 'scientism' and Buchanan attacked the 'scientification' of the discipline, by which he meant the 'mindless aping' of the natural sciences. The difference between the natural sciences and economics is not that hypotheses are not falsifiable. They are. It is, Buchanan argued, that the context is humanly constructed, not given.

All exchanges take place in a legal and institutional context that reflects political preferences. Economists can examine what is and what could be if these arrangements were changed. They can also say what *should* be so long as they recognise that when they do so they step outside the bounds of economic science: 'The economist moves outside scientific limits when she suggests that a person, or a group or the whole community, "should" exchange apples for oranges.'

Economists can predict that a legal reform will prevent some people from getting what they value, but if they go further they become political actors. For example, when Samuelson said (above) that some people deserve to lose their jobs he stepped outside science. Buchanan warned against the 'paternalist arrogance' of intellectuals who expressed opinions about the values others should pursue, 'whether in exchange dealings or in collective action'. Only if individuals are 'free to interact, one with another, can they achieve *their own* values'.[40]

In making this claim Buchanan is very much in the tradition of Adam Smith, who did not assume that low prices were the overriding objective. Individuals ought to be free to pursue their own ideals, and if an investor preferred to make a lower profit in his home market, who could say he was wrong? Economists for Free Trade assume that they know the prices, the quantities being supplied, and the products being demanded, when, as Hayek convincingly demonstrated, it is precisely those variables that remain to be discovered. The Minford model is also the kind of utopian scheme that Adam Smith warned against:

> 'The man of system … is apt to be very wise in his own conceit, and is often so enamoured with the supposed beauty of his own ideal plan of government, that he cannot suffer the smallest deviation from any part of it. He goes on to establish it completely and in all its parts, without any regard either to the great interests … which may oppose it; he seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess-board; he does not consider that the pieces upon the chess-board have no other principle of motion besides that which the hand impresses upon them; but that, in the great chess-board of human society, every single piece has a principle of motion of its own, altogether different from that which the legislature might choose to impress upon it.'[41]

The CGE model also assumes that tariffs are purely self-harming, when they are not. The current international trading order, based on WTO rules, does not have its own enforcement machinery. It relies on member states taking countervailing measures under the rules governing subsidies and countervailing measures. The WTO disputes procedure tries to stop vengeful retaliation and to ensure that countervailing measures are proportionate. Its weakness is that it allows unscrupulous countries to take advantage. China is the arch culprit but Germany, too, profits from the weakness of the euro.

If the UK unilaterally renounced all tariffs we would put ourselves in an impossibly weak position. International trade under WTO rules should mean making full use of those rules. It is worth remembering that Adam Smith was in favour of imposing tariffs when another country imposed duties on Britain. In such a case 'revenge', he said, naturally dictated retaliation, leading to the imposition of like duties on them. Retaliation would be likely to encourage the repeal of foreign tariffs and the inevitable extra expense was justified in order to gain trade.[42]

To summarise: economics is an immature science, as its recent failed efforts to predict the course of economic events after Brexit have revealed. Economic positivism over-states what economic analysis can achieve and mathematical models, in particular, give a false impression of precision. Its laws do not describe the efficient allocation of resources.

It offers an abstract model of the economy that occasionally fits reality. But, there is no such thing as 'the economy' in the sense of a phenomenon that can be understood by framing scientific laws. It is not an order with regularities that can be encapsulated in laws. Hayek's rival economic theory is more compatible with a free society and contends that a competitive market is a process for discovering new things. This constant flux of the vital components – the prices, consumer wants, the goods and services, the companies offering alternatives, the entrepreneurs who succeed or fail – is why economists have such difficulty devising models and goes some way to explaining why they now have such a bad reputation for prediction.

A market economy is not a system in which the equations work out, but a journey of discovery in which we are free within the rules of justice to use our own judgement to invent, create and learn as we go along. Hayek explained his view succinctly in an essay entitled 'Competition as a discovery procedure' but also in *Law, Legislation and Liberty*, where he also shows the intimate connection between a market economy and a free society.[43]

As Hayek constantly stressed, economists only have the data deployed in their models after the event. The vital purpose of economic activity is to discover what we do not already know. The data used in econometric models are precisely what we do not have in a dynamic process.[44] Even our own preferences as consumers are changing as we go along and learn what is available. A market economy is a useful thing because it allows each of us to discover through competition the best prices, the best products and the best producers, according to our own evaluations.

But these flaws are quite apart from the actual motives of some of the leading market actors. Many participants are not investing their resources in promising ventures; rather they are buying and selling items merely for the sake of gaining from the immediate transaction. This the subject of Chapter 3.

3

Doubts about capitalism

Today there are many supporters of a market economy who draw attention to fundamental flaws in modern capitalism. Concern has been growing for some time among media commentators, academics and regulators, but was brought to a head by the 2008-09 recession. In 2007, before the severity of the crisis had been realised, Martin Wolf identified the very different character of the new era. It represented 'the triumph of the global over the local, of the speculator over the manager, and the financier over the producer'. Hedge funds, he said, were 'perfect examples of the speculative trader and arbitrageur' and private equity funds were 'conglomerates that trade in companies with a view to financial gain'.[1]

Professor Simon Johnson, the former chief economist at the International Monetary Fund (IMF) and subsequently professor of entrepreneurship at the Massachusetts Institute of Technology (MIT), has likened the financial services industry in America to the kind of national elite he had encountered when dealing with financial crises in countries such as Mexico, the Ukraine, Russia, Thailand, Indonesia and South Korea. Typically the story was that powerful elites 'over-reached in good times and took too many risks'. The oligarchs that ran each country reckoned that their political connections would 'allow them to push onto the government any substantial problems that arise'. He found the US crisis to be disturbingly similar. It was also the result of a self-serving elite making 'ever-larger gambles, with the implicit backing of the government' and then using their influence to prevent reform. His advice was the same as it had been at the IMF when dealing with undemocratic regimes: 'break the oligarchy'. Proposals to break up the largest banks have even received support from Alan Greenspan. In October 2009 he said in a speech: 'break them up … In 1911, we broke up Standard Oil. So what happened? The individual parts became more valuable than the whole. Maybe that's what we need.'[2]

Professor Johnson noted the vast increase in the importance of the financial services industry relative to other sectors. From 1973 to 1985 it made 16 per cent of domestic US profits. In the 1990s the proportion rose to between 21 and 30 per cent, and after 2000 it shot up to 41 per cent. Expenditure on pay also rose. In 1982 average earnings in the financial services industry were 99-108 per cent of the average for all domestic private industries. In 2007 the figure was 181 per cent. The industry was able to achieve and maintain its influence because of the inter-changeability of Wall Street executives and US Treasury and other officials. A whole generation of policy makers, he said, had been 'mesmerized by Wall Street, always and utterly convinced that whatever the banks said was true'.[3]

British critics of the industry were also taken seriously. In 2007 Dr Paul Woolley, who made his fortune in fund management, put £4m into the Paul Woolley Centre for the study of Capital Market Dysfunctionality at the London School of Economics. As Dr Woolley said to *The Times* in September 2009, the truth is that markets in finance do not work: 'Everyone can be individually acting rationally and optimally, but the collective outcome can be catastrophic'. His unit is providing the academic analysis that he hopes will ultimately influence wider public opinion. He questions the fundamental assumptions of classical economics, and specifically the notion that the market for finance is made up of many providers who are prevented by competition from having a significant influence on the prices they charge. According to Woolley, what economists call the principal-agent problem dominates outcomes. Customers (the principals) rely on fund managers (the agents) who have different interests from them and who are able to take advantage of their superior knowledge and understanding of the industry. In economic terminology, there is an information asymmetry.

Pension fund managers, consultants, bankers and company directors, he says, 'stand between assets and their beneficial owners' and 'rationally, they behave in ways not in the interests of their clients'. He thought that such agents had a 'highly distortive' effect, including raising the cost of capital – something that would reduce productive investment – and 'drastically shrinking investment returns'.[4] In one of the unit's working papers he argues that fund managers have earned 'economic rents', or returns over and above what they would have earned under normal competition. In some cases they have been able to charge two per cent of the value of the fund annually plus 20 per cent of the profit and to charge additional 'portfolio fees'. Their 'unobservability' has meant that they can 'shirk' their duties to clients with impunity. For example, they may not check for bad risks despite taking high fees based on the belief that they are making careful enquiries before investing clients' money.[5]

The principal-agent problem, Woolley thought, had allowed insiders to capture a disproportionate share of the returns of the productive economy. Lord (Adair) Turner, former chairman of the Financial Services Authority (FSA), agreed. Some financial activity, he famously said, was ‘socially useless’. However, he was not optimistic about the potential effectiveness of regulation. From the regulator’s perspective it was so ‘opaque’ that there was ‘nothing you can actually get your arms around to regulate’.[6]

David Pitt-Watson, founder and chairman of Hermes Equity, also attacked the industry for over-charging and taking undue risks with their customers’ money. In one of a series of reports published by the Royal Society of Arts (RSA), he said, ‘while usually ensuring their own interests are protected, those who have invested on our behalf have allowed unjustified and unwise risks to be taken with our money’. Moreover, he thought that the current system of private pension provision might be ‘taking up to 40 per cent or more of our money in fees and costs’ compared with 10 per cent for schemes following best practice in other parts of the world. He conjectured that a reformed system could add 50 per cent to private pensions.[7]

No less severe in his criticism was John Kay, a respected columnist for the *Financial Times* and Fellow of St John’s College Oxford. The industry was ‘a monster that is out of control’. The scale of resources the sector demanded, the size of the personal financial rewards it offered, and the political influence it wielded were all excessive. It had distorted the ‘values of whole societies’. The City, he said, contained ‘some of the most selfish people outside prisons’.[8]

He characterised the industry as a casino attached to a utility. The utility provides useful services, such as making and receiving payments and arranging borrowing and lending. The casino tries to profit from arbitrage, that is trading purely for the sake of profiting from price differences, however small. The users of the utility are interested in the fundamental value of the assets, whereas the players in the casino are pre-occupied with 'the mind of the market', which has become one of the main influences on prices.[9]

Another industry insider, Roger Bootle, founder and managing director of Capital Economics, an organisation that advises the financial services industry, concluded in his book *The Trouble With Markets* that 'there is a tendency for financial markets to expand beyond their social usefulness' because the rewards are so great and because of 'the human urge to gain great riches quickly, with minimal effort'. 'Ensuring a prosperous and secure future for us all will involve the financial sector being cut down to size.' After a lifetime in the industry he did not believe that 'the way in which financial markets have operated over the last 30 years encourages a healthy attitude to wealth, or to fellow human beings'. The individuals who rose to the top of financial institutions 'are often notable chiefly for their greed'. Worse still, disproportionate rewards were a 'slap in the face' for members of society who just got on with doing a decent job. The mentality of the industry was 'deeply corrosive of the values that underpin successful business'.[10]

The 2008 crisis also uncovered a 'deep-seated failure of the corporate system'. The financial sector was 'hell-bent on pursuing its own profit, while undermining, not promoting, the public good, and a system of corporate governance where managers have been pursuing either their own interests or the short-term performance of the share price – which often came to the same thing.' Much activity was within the law, but Bootle had also found that financial markets were 'uniquely prone to dishonest activities'.[11]

Others vehemently deny that crony capitalists took advantage, or that the 2008 crisis was the result of greedy individuals on Wall Street. They say that blame lies with federal governments of both parties from President Carter onwards, who obliged American mortgage providers to issue subprime loans to people who could not afford them. Peter J. Wallison of the American Enterprise Institute (AEI) is perhaps the foremost critic.[12]

The thesis has been examined by Richard Posner, a prolific writer, senior lecturer at the University of Chicago Law School, and a Circuit Judge in the US Court of Appeals on the Seventh Circuit. He is also a well-regarded enthusiast for a market economy and was a co-contributor with professor Gary Becker to the Becker-Posner Blog until the death of Becker in 2014. Posner tests the proposition that making mortgage loans to people who were at high risk of defaulting was the result of government policies and not private business decisions.[13] The Federal National Mortgage Association (FNMA), commonly known as Fannie Mae, and the Federal Home Loan Mortgage Corporation (FHLMC), known as Freddie Mac, were private corporations that were also government-sponsored enterprises (GSEs). Because they were government sponsored, lenders assumed that they would not be allowed to go out of business and so they were able to borrow at very low rates of interest. Consequently they were able to earn huge profits while encouraging a 'nation of homeowners'. Posner found that critics exaggerated the impact of federal policies:

> 'The broker-dealers and other banks that created mortgage-backed securities by securitizing mortgages sold to them by mortgage specialists, and that then sold interests in the securities to other banks, hedge funds, and other investors, did not do this because of the GSEs… There was no governmental pressure on anyone to create or invest in mortgage-backed securities.'[14]

In any event the Community Reinvestment Act, which was intended to increase the number of loans made to low-income families, did not apply to financial intermediaries other than commercial banks and savings and loans associations, known as thrifts. Financial institutions engaged in highly risky lending with their eyes wide open 'because such lending was vastly profitable; too profitable for the good of the economy as a whole, but too profitable only because interest rates were too low and banking regulation too lax.'[15]

Government regulation played its part, but no one forced 'casino capitalists' to make loans to people with little chance of paying them back, and no one compelled financial institutions to bundle bad loans with good loans to conceal the true level of risk.

FOUR CRITICISMS OF NAÏVE CAPITALISM

I will suggest four main criticisms of naïve capitalism. First, that the rules of the game have been rigged to avoid personal responsibility, contrary to one of the principal ethical justifications for freedom. The prime recent example is the reliance of the financial services sector on a public rescue in the event of failure. Second, that laws and regulations have been altered under cover of 'deregulation' to make it easier to make money from pure gambling instead of investing in productive assets. Third, that the rewards from the 'financialisation' of capitalism have gone to a small elite at the expense 0f everyone else. And fourth, that a corporate culture of plundering has developed.

Escaping personal responsibility

The behaviour of some businesses has come under strong attack by many who are strong defenders of freedom and a market economy. They find that modern capitalism has assumed a form that leads to vast wealth for a few and little for the many, not because they played the game successfully, but because they rigged the rules. They criticise not capitalism as such but a specific form, crony capitalism.

For example, David Stockman, the former budget director for President Reagan, has severely criticised the abuse of financial power in America, a development that was replicated in the UK. In *The Great Deformation* he describes how business leaders used the power of the state to shield themselves from market forces. If they were true to market philosophy they would expect to live with the results of their own folly, but instead they wanted taxpayers to bail them out. The moral case for private property is that it creates the possibility of personal responsibility. The case against crony capitalists is that they seek to avoid responsibility – they want to receive the upside of any risk they take and want any downside costs to fall on others.

Lehman Brothers was allowed to go under, but the next day a decision was made to bail out the insurer, the American Insurance Group (AIG). The official reason was that it was a highly interconnected insurer that would cause 'contagion' and drag down other companies with it. In 2009, the US House of Representatives Committee on Oversight and Government Reform began to investigate the bailout of AIG by the Federal Reserve Bank of New York. It reported in January 2010.[16] It examined Treasury Secretary Timothy Geithner's claim that the point of AIG's bailout was to protect AIG's insurance policy holders. According to Geithner:

> 'AIG was providing a range of insurance products to households across the country. And if AIG had defaulted, you would have seen a downgrade leading to the liquidation and failure of a set of insurance contracts that touched Americans across this country and, of course, savers around the world.'

The committee quoted the conclusion of the *Wall Street Journal* that the real beneficiaries of the bailout had been the big banks who were counterparties to AIG's credit default swaps (CDS):

> 'Yet, if there is one thing that all observers seemed to agree on last year, it was that AIG's money to pay policyholders was segregated and safe inside the regulated insurance subsidiaries. If the real systemic danger was the condition of these highly regulated subsidiaries – where there was no CDS trading – then the Beltway narrative implodes.'

AIG's reserves covering its insurance contracts were protected by state laws that would have prevented the use of insurance reserves to cover losses on credit default swaps, which was where the real problem lay. These losses would have fallen on a handful of huge institutions that could have absorbed them. The committee reported that Geithner had 'stonewalled the committee's investigations at every turn':

> 'Secretary Geithner's inconsistent statements and apparent contradictions raise important questions about the decision to not only funnel billions of taxpayer dollars to AIG's counterparties, but also the decision to bail out AIG itself.'[17]

The committee concluded that the bailout of AIG's CDS counterparties meant that '$62.1 billion of taxpayer money may have been wasted'. By January 2010, $16.5 billion had gone to Société Générale, $14 billion to Goldman Sachs, $8.2 billion to Deutsche Bank, and $6.2 billion to Merrill Lynch. There had been 'enforced favouritism' and the secrecy, concealment and lack of transparency had serious implications for the health of democracy and free markets.[18] Some banks in Britain also received many billions in public support. Nearly ten years later RBS is still majority-owned by taxpayers.

By putting the responsible individual at its heart liberalism is elevating and humane. A market economy based on private property is no less elevating and humane, but not if it becomes a system of trading merely for the sake of gaining from buying and selling and which seeks to impose the costs of reckless gambling on other people. Far from being humane, everything, including employees, has been turned into a potential commodity.

One of the striking features of the great recession of 2008 compared with earlier scandals has been the low number of criminal prosecutions. The savings and loans scandal of the 1980s led to many more. The *New York Times* reported in 2014 that there had been 839 convictions as a result of the savings and loans scandal, whereas by 2014 only one Wall Street executive had been convicted as a result of the 2008 crisis.

To sum up: the moral case for a market economy based on private property is that it encourages personal responsibility. For many years corporate executives in financial services sought to escape responsibility for their own actions.

Legislating and de-regulating to open up the casino

Very few people object to high incomes or wealth when they have been acquired by fair-and-square means, including sheer luck. A market is always and everywhere a contrivance of law and regulation. The only question is what should those laws be. Leo Melamed, chairman of the Chicago Mercantile Exchange (CME) from 1969, has shown how traders lobbied to change the rules to suit their interests. In 1972 the CME created the International Monetary Market (IMM), regarded as the world's first financial futures exchange. Futures for US Treasury bills were launched in 1976, Eurodollars in 1981, and stock index futures in 1982.

Under the banner of de-regulation or reducing 'interference' they pressed for new regulations that suited their commercial interests. Melamed describes a key moment in 1981 when the Commodity Futures Trading Commission (CFTC) ended the link between trades and physical delivery. Until then the law stipulated that the difference between gambling and futures was that futures 'contemplated' delivery. Melamed continued: 'In other words, without delivery, we were not much different from a gambling den – exactly what our detractors had been saying for years'.[19]

Melamed describes his colleagues as they were in 1971 when contemplating the establishment of the IMM: 'We were a bunch of guys who were hungry. We were traders to whom it did not matter whether it was eggs or gold, bellies or the British pound, turkeys or T-bills. We were babes in the woods, innocents, in a world we did not understand, too dumb to be scared.'[20]

He has frequently stressed how vital it had been to end the requirement for physical delivery. He jokes that his father had feared that one day a load of onions (a commodity in which the CME traded futures) would get delivered to his home address. He had good reason for his fear. J.M. Keynes very nearly had to take delivery of tons of wheat when the price fell unexpectedly. He was speculating on behalf of Kings College and contemplated storing the wheat in the crypt of Kings College Chapel until he realised it was too small.[21] (Fortunately for him, the price went up before delivery was due.)

Cash delivery, according to Melamed:

> 'unshackled futures from its most burdensome constraint, one that represented an insurmountable wall around its existence. Cash settlement in lieu of physical delivery enables us to contemplate and explore the market applicability of

> concepts and intangibles never before possible for futures trade. This unlimited potential will no doubt challenge the minds of even the most provocative market innovators.'

He continued:

> 'Allow me to state for the record that this new era would most likely never have transpired without the existence and courage of the Commodity Futures Trading Commission (CFTC). The concept of cash delivery – so simple and universally accepted a methodology for settlement of contractual obligations (one that is commonplace in every other field of business or walk of life) – was obstinately and irrationally barred to us and would have remained so were it not for the CFTC. It was only by virtue of the public faith placed in the wisdom of a congressionally-ordained entity that the issue of cash delivery had a chance to be resolved in our favour. It is to the CFTC's everlasting credit that this was accomplished and unquestionably will be recorded as one of its paramount achievements.'[22]

The CFTC resisted these changes before Reagan took office in 1981 but then overrode state laws. Knowing full well what they were doing, under the flag of de-regulation, crony capitalists increased opportunities for arbitrage.

As Melamed's remarks reveal, they did not make a mistake because of their naïve faith in deregulation. They knew what they wanted. The same problem had occurred before, and legislation had been enacted to prevent a recurrence. Bucket shops emerged at the end of the nineteenth century to allow gambling on the movement of share prices. Members of the public made bets in bucket shops which then used the cash placed on bets to buy and sell shares to manipulate the price so that the bucket shops could not lose. Bucket shops were outlawed in Massachusetts in 1907 and New York in 1908, following scandals. The legislation defined the difference between gambling and investment. The key difference was physical delivery or a bona fide sale of a security.

It was these laws that were circumvented by the actions of the CFTC. Stockman's charge is that the CFTC in effect overrode the Tenth Amendment, the part of the US Constitution that assigns powers to the states if they are not explicitly given to the federal government. States had a long recognised right to regulate gambling and many states, including Illinois, had anti-gambling statutes. As Stockman writes: the CFTC 'accomplished nothing less than an abridgement of the Tenth Amendment'.[23]

Melamed understood the reason for requiring physical delivery. In a speech given in 1996 he said:

> 'The delivery mechanism to settle futures contracts was intended solely to stop would-be "cornerers" from driving prices beyond their intrinsic values. The threat of delivery acted as an enforcer, ensuring that prices of a futures contract and its cash market equivalent converged at the date of maturation of the contract. But while that was important in agriculture, it was unnecessary in finance. No one was likely to corner the Deutsche mark. Indeed, futures markets were used as an insurance policy, not to actually take delivery. All a trader wanted was the difference – in cash – between the value of the instrument at the time it was bought and the time it was sold, or vice versa.'[24]

Melamed explains the importance of gaining legitimacy from the academic world. At a dinner in 1982 at which Milton Friedman was guest of honour, Melamed explained how important an article by Friedman in 1971 had been and he reminded guests that the Secretary of the Treasury, William Simon, had not wanted to approve the T-bills futures contract until Milton Friedman telephoned him in 1976. The contract was approved on the same day.[25]

Deregulation continued and in 2000 the Commodity Futures Modernisation Act ended the possibility of regulating Credit Default Swaps (CDS). The CFTC had wanted to regulate them but the Act prevented it. In 1990 credit default swaps did not exist. The CDS market grew from about $100 billion a year in 2000 to $12 trillion by 2005, the equivalent of the whole US economy.[26] By 2007 they were valued at nearly $60 trillion.[27]

Lord Turner, former chairman of the FSA, has quantified the scale of trading for its own sake. Foreign exchange trading grew faster than real trade. By 2008 foreign exchange trading was 73 times the value of trade in goods and services. The value of oil futures was 10 per cent of oil production in 1984. By 2013 it was ten times the value of oil production.[28]

In 1980 there were no derivatives. By 2007 they were worth $400 trillion, nine times the value of world GDP. In 1995 collateralised debt obligations (CDOs) did not exist. In 2006 new CDOs worth $560 billion were issued.[29]

According to Stockman this showed that Wall Street looked upon everything as an opportunity to trade. Worse still the Republican establishment had become apologists for crony capitalism. The financial sector served Wall Street, not Main Street:

> '…instead of stimulating household and business credit formation and thereby reflating Main Street consumption and investment, central bank credit flowed entirely into speculative carry trades, structured finance and corporate financial engineering. So doing, it massively inflated financial-asset values and turned Wall Street into a bubble-ridden gambling casino.'[30]

Stockman noticed that much de-regulation of the 1980s opened up new opportunities to trade, but not necessarily to invest in productive assets. Some market fundamentalists avoid discussion of this problem because they fear it will give ammunition to opponents, but Adam Smith was a severe critic of speculators. In *The Wealth of Nations*, Smith often condemned 'projectors', as speculators were called in his own time. For example, he favoured a legally imposed maximum interest rate of five per cent at a time when the market rate was about four per cent. If the legal rate of interest went up to eight per cent, he said, then more money would be lent to 'prodigals and projectors', who alone would be willing to pay that much. 'Sober people', he argued, would only pay rates that would allow them to make a profit from solid ventures. Without a maximum of about five per cent, money would be thrown into the hands of people who 'were most likely to waste and destroy it'. With a legal maximum 'the capital of the country is thus thrown into the hands in which it is most likely to be employed with advantage.' When discussing banks Smith similarly criticised 'chimerical projectors, the drawers and re-drawers of circulating bills of exchange, who would employ the money in extravagant undertakings'. He favoured the 'sober and frugal debtors' who would be more likely to employ the money 'in sober undertakings which were proportioned to their capitals, and which, though they might have less of the grand and the marvellous, would have more of the solid and the profitable'.[31]

The financial elite has extracted excess wealth

Prominent Conservative intellectual Michael Gove said during his short-lived leadership campaign in July 2016 that governments had 'broken the British contract', which promised that hard work would lead to a better life. The referendum laid bare the truth about globalization, free movement and the march of progress in recent decades: 'it has broken the British contract which said: if you work hard and throw everything you've got into building a better life – then that better life can be built.'[32]

The change in the culture of some of our longstanding institutions, such as building societies, has been typical. They began as mutual societies to help members buy a house. If people paid off the loan early so much the better; it released funds to help other members.

Today, the mortgage sector is dominated by self-serving individuals from the financial services industry who impose penalties on people who pay back early. Why? Because their aim is not to help people buy a house but to make money from people who need somewhere to live. People who pay off their loans early often do so because interest rates have fallen, which means they can re-mortgage at a lower interest rate. This leaves the lender with money that can only be re-lent at the new lower return. The traditional building society would have been pleased, but today financial institutions demand a penalty of thousands of pounds to compensate lenders for lost earnings.

Lord Turner has argued that finance 'has a distinctive ability to grow beyond its socially useful size, making private profit from activities that add no true social value.'[33] He contended that '… financial markets when left to free-market forces, can generate activity that is privately profitable but not socially useful. There can be too much finance, too much trading...'[34]

Turner notes that much economic theory treats the sector as if it is servicing the real economy, when it does no such thing. In the 1950s, when the USA was economically successful, financial service made up 3 per cent of GDP. In 2007, just before the recession, the figure was 8 per cent.[35]

Turner deploys measures of the growth of the financial sector presented by Haldane et al in *The Future of Finance*. Its importance has varied over the decades. From 1856 to 1914 the value-added of UK financial services grew 3.5 times more rapidly than national income. From 1914 to 1970 it grew less rapidly than GDP. Subsequently, especially after 1980, it grew twice as fast as UK national income.[36]

There were two main reasons: there was more borrowing and more asset management. In the USA private sector debt (households and business) in 1945 was 50 per cent of US GDP. By 2007 it was 160 per cent. In the UK in 1964, household debt was 15 per cent of GDP. By 2007 it was 95 per cent.[37]

Another approach has been to compare the growth of the median income with the income of the top few. The median income hardly increased in the twenty years up to 2016, which meant that only a few people at the top had benefited from rising GDP. The material rewards went to the elite in financial services, especially those with existing assets.[38]

Philippon and Reshef have also shown how the financial services sector took higher pay. They compared financial sector salaries with those of people with comparable skills in other sectors and called the difference the 'excess wage'. In the 1920s finance played a big role in the economy until the 1929 crash, and the 'excess wage' rose from zero to about 40 per cent. From 1930 until 1980 the excess varied from zero to under 5 per cent and was sometimes negative. Just before the crash of 2007-08 it had increased to 50 per cent.[39]

Luis Aguilar, head of the US Securities and Exchange Commission (SEC), said in a speech in February 2010: 'Many have noted that there has been a shift in the nature of financial services toward casino capitalism — or, toward profiting on bets about price movements, rather than a company's ability to make money by producing goods and services.' He took the view that the financial services sector had harmed manufacturing in the US. The essential role of the financial services sector was to facilitate the allocation of capital to economically productive uses. He thought there had been a 'clear failure … with widespread mispricing of assets, trillions in losses, and, perhaps most disheartening, painful levels of unemployment and underemployment'. Despite its failure, the financial services sector had expanded significantly, and the salary and bonuses of people working in financial services outpaced the real economy. It could be said, he concluded, 'that our society's capital was allocated by financial services, to financial services'. There was 'a disconnect between the lavish bonuses, salaries, and other rewards on the one hand — and the poor job the industry did for our economy on the other'.[40]

To summarise: the criticism that the financial elite has extracted wealth for itself at the expense of the real economy, is not just the habitual complaint of Marxists, it is a well demonstrated fact which has harmed the real economy.

Corporate plundering

As long ago as 1932 Berle and Means in *The Modern Corporation and Private Property* feared that 'corporate oligarchy' would lead to 'an era of corporate plundering'. Earlier still, both Adam Smith and J.S. Mill, had voiced their fears that joint stock companies would lead to 'jobbing', or using a position of trust for private advantage.

According to Professor George Akerlof, organisations that can rely on government guarantees in the event of losses have an incentive to 'loot': 'the normal economics of maximizing economic value is replaced by the topsy-turvy economics of maximizing current extractable value'.

If managers realise that they can 'extract more from a firm by maximizing their present take, any action that allows them to extract more currently will be attractive'. He calls the disparity between what the managers can capture and the losses that they create 'looting'.[41]

In 2012 Martin Wolf argued that the 'core institution of contemporary capitalism' the limited liability shareholder corporation had 'inherent failings', the most important of which was that companies are not effectively owned. As a result they are vulnerable to 'looting' by executives. Shareholder control was often an illusion and maximisation of shareholder value 'a snare, or worse'.[42]

David Stockman calls it strip-mining: 'the companies most Americans work for have been strip-mined to the tune of trillions in order to fund financial engineering gambits like stock buybacks and M&A deals rather than productive investments in plant, equipment and technology.'[43]

Share buy-backs were often a device for manipulating earnings per share without increasing earnings. Under the guise of increasing shareholder value, executives argue for personal incentives to align their interests with those of shareholders. They designed schemes that allowed them easily to increase what they could take out of the company, such as earnings per share, a measure easily manipulated by buying back shares.

Takeovers can be seen in the same light. The market in corporate control does not work well. Often takeovers do not lead to the removal of management. Lord Sainsbury has told how he was encouraged to sell his supermarket chain. The would-be buyers had wanted him to stay on after they had bought the company and planned to borrow more so that they could pay themselves a dividend from the loan, then re-sell later. Such takeovers are extraction strategies, not a method of incentivising management.[44] Such corporate raiders identify targets, not because they are badly managed, but because they can afford to borrow more and pay an income. Often targets are chosen because they own property that can be sold. Some retailers, for example, own the shops they sell from and these properties can be sold and leased back. Better still they can be sold to a company owned by the same people who took over the firm. Then they can profit from the capital gain and take the rental income.

To express criticisms such as these is to invite being accused of having an anti-business attitude. However, the balance has tipped against unashamed apologists for any business behaviour whatsoever, and the time has come for a principled defence of freedom and a market economy. In the next chapter I will argue that inclusive capitalism is a noble ideal.

4

Agenda For Independence: Inclusive Capitalism

There are strong parallels between the climate of opinion during the depression of the 1930s and the state of public opinion after the 2008 recession. The hardship of the 1930s led many to have second thoughts about the political and economic institutions that had evolved up to that time. Keynes is perhaps the most famous but there were many others, including economists at the University of Chicago, which was to become a bastion of free-market thought in the 1970s and 1980s. Professor Henry Simons wrote 'A positive program for laissez faire' in 1934. It was reproduced in *Economic Policy For a Free Society* and in the foreword, Aaron Director of the University of Chicago Law School, argued against the 'horde of reactionaries' who think that defending a market economy entails pure negativism. On the contrary, he agreed with Simons that only the 'wisest measures of the state' could maintain a free-market system.[1] Both thought that the failure to maintain stable money had been akin to a crime:

> 'The failure of the state to discharge its responsibility for regulating the supply of money constituted the outstanding example of the disastrous consequences of the philosophy of negativism we inherited from the nineteenth century. The attempt of the state to discharge its responsibility through

> discretionary authorities – central banks – constituted the first departure from the basic faith of liberals in the rule of law.'[2]

Simons argued that libertarian policy called 'essentially for planning to sustain freedom'.[3] Writing when memories of the 'robber barons' were still fresh, he was scathing about the power of massive business corporations. America, he thought, 'might now be better off if the corporate form had never been invented'. The 'direct dismantling of corporate empires' had become necessary.[4] Unlimited grants of power to corporate bodies had been one of the greatest sins against free enterprise. The corporation was suitable for operating companies that needed to secure economies of scale, but not otherwise. He even went so far as to advocate state ownership of utilities and railroads. Excessive charges weakened the ability of other businesses to flourish. If they could not be regulated to ensure competition, then it would be better to take them over and manage them directly.[5]

He argued that the 'so-called failure of capitalism' could reasonably be interpreted as 'primarily a failure of the political state in the discharge of its minimum responsibilities'. Governments had failed to uphold competition and prevent monopoly and had 'evaded – when they have not abused – their responsibility of controlling the currency'.[6] Simons' plan to curtail private banks was supported by Milton Friedman who was to became one of the best known champions of the free market revival of the 1980s. Above all, the Chicago economists of the 1930s and 1940s feared reckless private credit creation which relied on government guarantees. They put forward the Chicago Plan, a scheme for 100 per cent reserve banking.[7]

Today Keynes is associated with the political left, but he was always an economic liberal and in his early years he had been a defender of laissez-faire capitalism.[8] But by the 1930s he was arguing that the conditions that made it justifiable in the nineteenth century no longer applied. He had previously thought that any interference with the international division of labour was the 'offspring of ignorance out of self-interest' and shared the belief of free traders that they were serving the cause of liberty – freedom for personal initiative and the untrammelled mind against privilege and monopoly. He thought that making the best use of the world's resources would reduce poverty and that the promotion of trade would promote world peace.

By 1933 he was telling an international conference that laissez faire had not worked out as its champions, such as Cobden, had predicted. Competing national efforts to capture foreign trade had not brought peace. On the contrary, the penetration of local markets by foreign owners and the reliance on overseas markets for income had led to economic imperialism, including what became known as the scramble for Africa. In 1884 the Berlin conference had been attended by 14 nations to carve up Africa into agreed zones of influence.

In the nineteenth century Keynes argued that two things had made 'economic internationalism' beneficial. First, European migrants spread culture and investment overseas, notably by building railways. This kind of internationalism, said Keynes, was not at all like the 'part ownership of the AEG of Germany by a speculator in Chicago'. The ownership and control of companies had been increasingly divorced. Owners bought and sold partial interests in companies and had neither knowledge of what they possessed nor responsibility for what they owned. It might well be advantageous to invest anywhere in the world according to the marginal efficiency of a project, but remoteness between ownership and operation cancelled out the gain.

Second, in the nineteenth century there were enormous differences in opportunities for technical training which had made national specialisation more advantageous. By the time he was writing, the technical knowledge on which enterprise depended was far more widely diffused. Some division of labour was wise when it was the result of climate, natural resources and even entrenched culture, but most modern products, he argued, could be made in many places with almost equal efficiency. To make them in our own country might cost something extra, but it was 'a luxury which we can afford if we happen to want it'.

He was acutely aware that the freedom that liberals had traditionally sought had a political dimension. Each nation should be allowed its own experiments. We were, he thought, each entitled to have a go at working out our own salvation. Why should nations be at the mercy of world forces? We wish, said Keynes, to be 'as free as we can make ourselves from the interferences of the outside world'.[9] In his case for leaving the gold standard Keynes pointed out that among the forces to which Britain might be subject was the Federal Reserve Board of the United States. It would have effective control of 'our price level and the regulation of the credit cycle'.[10]

Keynes was attacked by Lionel Robbins, one of the leading economists of his time, for abandoning his earlier idealism. Keynes replied:

> 'Professor Robbins taunts me in conclusion with abandoning "the service of high and worthy ideals in international relations" for "the service of the mean and petty devices of economic nationalism". I know that he sincerely feels this, and that for him, as for many others, free-trade stands as a banner and as a symbol of fundamental reason and decency between nations. Free trade unbesmirched invokes old

> loyalties, and recalls one of the greatest triumphs of reason in politics which adorn our history. It is a poor retort, perhaps, to this, to say that one must not let one's sense of the past grow stronger than one's sense of the present and of the future, or sacrifice the substance to the symbol.'[11]

Keynes had expressed a similar view in his essay on Malthus, published in 1933. He concluded that his work belonged to the long English tradition of humane science, a 'tradition marked by a love of truth and a most noble lucidity, by a prosaic sanity free from sentiment or metaphysic, and by an immense disinterestedness and public spirit'.[12] Keynes regretted that it was the abstract spirit of Malthus' contemporary Ricardo that had set the tone of economics rather than the humane science of Malthus. The two were close friends until Ricardo died and their correspondence has been preserved. An exchange in 1817 explains the difference between their approaches. Ricardo wrote:

> 'It appears to me that one great cause of our difference in opinion on the subjects which we have so often discussed is that you have always in your mind the immediate and temporary effects of particular changes, whereas I put these immediate and temporary effects quite aside, and fix my whole attention on the permanent state of things which will result from them. Perhaps you estimate these temporary effects too highly, whilst I am too much disposed to undervalue them.'

Malthus replied:

> 'I agree with you that one cause of our difference in opinion is that which you mention. I certainly am disposed to refer frequently to things as they are, as the only way of making one's writings practically useful to society, and I think also the only way of being secure from falling into the errors of

> the taylors of Laputa, and by a slight mistake at the outset arrive at conclusions the most distant from the truth. Besides I really think that the progress of society consists of irregular movements, and that to omit the consideration of causes which for eight or ten years will give a great *stimulus* to production and population, or a great check to them, is to omit the causes of the wealth and poverty of nations – the grand object of all enquiries in Political Economy.'[13]

Laputa was an island in *Gulliver's Travels*. Its tailors were in the habit of taking measurements for clothing with the aid of instruments such as quadrants and then working out the size using algebra. Laputans were notorious for wearing clothes that did not fit.

Keynes felt that capitalism had not lived up to the ideals claimed by Robbins:

> 'The decadent international but individualistic capitalism, in the hands of which we found ourselves after the War, is not a success. It is not intelligent, it is not beautiful, it is not just, it is not virtuous – and it doesn't deliver the goods. In short, we dislike it and we are beginning to despise it. But when we wonder what to put in its place, we are extremely perplexed.'

These words could have been written today. A market economy is useful and a vital safeguard of liberty, but some of its manifestations are indefensible, as Chapter 3 argued.

By 1933 Keynes had concluded that the first aim of economic policy should be prosperity for British citizens. In an article published in the *New Statesman* entitled 'national self-sufficiency' he labelled his view 'economic nationalism'. He could have called it 'inclusive economic internationalism' because he saw clearly the benefits of trade within a rules-based order that allowed the benefits of specialisation and trade to be widely shared, and he was conscious of the importance of allowing space for invention and free adaptation to perceived risk and uncertainty. Keynes envisaged openness to everything connected with the free mind, which implied open borders for ideas, art, science and travel. He thought we should be open to overseas goods and services too, but only after ensuring full employment:

> 'Ideas, knowledge, art, hospitality, travel – these are the things which should of their nature be international. But let goods be homespun whenever it is reasonably and conveniently possible; and, above all, let finance be primarily national. Yet, at the same time, those who seek to disembarrass a country of its entanglements should be very slow and wary. It should not be a matter of tearing up roots but of slowly training a plant to grow in a different direction.'[14]

Free trade theory asserted that everyone would benefit financially – even displaced workers would soon find themselves going 'up the value chain' into better paid work. Keynes noticed that this is often not what happened. Many remained out of work for years, or in and out of low-paid jobs, with significant falls in their lifetime earnings that were never recovered. The same outcomes can be seen today, as studies of the 'China shock' described in Chapter 2 reveal.

Some of Keynes' critics have accused him of autarky, but he never advocated economic isolation, merely a greater focus on domestic prosperity.[15] In the same year in which he wrote his essay on national self-sufficiency, he wrote *The Means to Prosperity*, in which he advocated increasing government borrowing to finance a major programme of house building to employ people and produce an asset. Some of the income earned would, he expected, be used to buy imports, which he thought was more beneficial to other countries than lending them money. By purchasing imports a similar virtuous circle could be stimulated in other countries.[16] Far from focusing exclusively on our national interest, even while advocating how best to reduce unemployment at home, he was considering the potential benefits for other nations. Moreover, he was one of the architects of the post-war regime of international trade based on the Bretton Woods agreement, and the new institutions of the era, the GATT, the IMF and the World Bank.

To summarise: Keynes thought that each country should be free to experiment. We may not know where we are going, we know only that we shall discover our aims and ambitions as we go along. Keynes said he wanted as much private judgement, initiative and enterprise as possible, but he thought that economic internationalism with free movement of capital – often called globalisation today – would condemn the UK to a lower degree of prosperity.

Keynes did not advocate a purely economic doctrine. He put freedom and democracy first and he remained internationalist in two ways. Keynes wanted freedom of ideas, art, science and travel, which implied openness of mind, a critical outlook, scepticism towards orthodoxy and monopoly power, and celebration of dissent. And he put domestic prosperity first only to equip Britain to be fully engaged internationally, trading with nations that accept the rules of trade, and assisting nations in poverty. His rebalancing of the national and the international was for the sake of our common humanity. In practice, the globalisation of his day had often meant remote ownership, which encouraged irresponsibility.

The quality of Keynes' reasoning stands in contrast to the distinction recently promoted by Tony Blair and other enthusiasts for globalisation, namely between open and closed societies. Tony Blair first contrasted 'open versus closed' in a speech as prime minister to the TUC in 2006. As he put it: 'There is a debate going on which, confusingly for the politicians, often crosses traditional left/right lines and the debate is: open v closed.'[17]

He deviously implies that anyone who wants to control immigration or who questions unfettered free trade has a closed mind, whereas he has an open mind. He has repeated the distinction over the years, recently in an interview in 2017 for an online Italian magazine: 'I don't think … the answer to the problems and the challenges of globalization is … to shut the world down'. The 'basic attitude' he insists 'is open minded not closed minded and which is in favour of accepting globalization as a fact, accepting its benefits but preparing people for its consequences'. If you try and stop globalization or hinder it, 'you end up either with protectionism, isolationism or as we can see all over Europe today political battles over immigration'.

Blair conflates open borders with open minds, a mistake he could have avoided if he had read Keynes' 1933 essay. Keynes was in favour of open minds but strongly argued that it was possible to be simultaneously open minded and in favour of putting the economic success of our own citizens first. He reveals the difference between a thinker who is genuinely open to persuasion and willing to change his mind in the light of evidence, and a propagandist whose sole concern is to draw others towards a previously determined position. Blair lacks objectivity and self-criticism and is constantly alert to the emotional appeal of words. This personality trait was recently highlighted by Sir John Chilcot, chairman of the Iraq war inquiry, when he said: 'Tony Blair is always and ever an advocate. He makes the most persuasive case he can. Not departing from the truth but persuasion is everything. Advocacy for my position, "my Blair position".'[18] But to be continuously engaged in persuading is very different from continuously searching for the truth. It allows Blair to portray his opponents as closed minded when it is his mind that is closed.

Keynes' view is not completely at odds with Adam Smith's philosophy. In fact in one of the most widely quoted passages in the *Wealth of Nations*, when Smith refers to the 'invisible hand', he is arguing that individuals with capital will naturally tend to favour domestic investment over foreign:

> 'As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestick industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the publick interest, nor knows how much he is promoting it. By preferring the support of domestick to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.'[19]

Smith thought that investment in the home market was the natural choice unless, as a result of unwise actions of the government or other 'particular causes', people may sometimes be 'driven off and repelled from it towards more distant employments'.[20]

As Keynes and Smith both clearly saw, a free society is about more than the economic wellbeing of its members. The primary aim is personal freedom and democracy. A market economy is a bulwark of freedom. Private property is a guarantor of personal responsibility and allows prosperity to be shared. If we were forced to choose between prosperity and freedom, we would choose freedom. Keynes rejected laissez faire but not in favour of collectivism. He closed his 1933 essay by saying that, if the experiments he wanted to see turned out like Stalin's Russia, he would 'soon be back' to his old nineteenth-century ideals which allowed space for the free play of 'mind on mind'.

Working out our own salvation: guiding principles of reform

There are two ways of viewing political power: as an opportunity to exert control over the lives of others; or as a trust for all members of society. Independence allows us to restore our system of government as a trust for the common good. The EU is a system of control by a self-chosen few, whereas the Westminster system compels leaders to serve as trustees for all members of society. It is based on the ideal of leaders who are citizens holding office for the time being and who must govern by consent. I have described this ideal in *Democratic Civilisation or Judicial Supremacy?*[21]

An inclusive economic policy

Independence also allows us to pursue an inclusive political and economic policy. The primary aims of government should be to enhance personal freedom and to create the conditions in which all members of society can improve the common welfare in mutual cooperation with other people. Inclusivity implies the idea of a nation as a kind of membership association. Earlier writers often spoke of a 'common-wealth' that aimed to create conditions that would allow everyone to succeed by their own ingenuity and effort.[22] Creating conditions for enterprise and personal freedom is not the same thing as creating a command-and-control economy. But a government that upholds the interests of all members of society has a responsibility to perform well the tasks that it alone can carry out: ensuring sound money, upholding just laws, applying fair taxation, preventing monopoly, and ensuring responsible government spending and investing.

Outward-looking internationalism

Independence will permit us to renew our commitment to outward-looking internationalism instead of the self-serving regionalism of the EU. By common consent the two biggest international challenges are how to secure peace, including the eradication of terrorism, and how to overcome poverty. We should continue to play a full part in the UN, as one of five permanent members of the Security Council; and to play a full part in the work of the International Monetary Fund and the World Bank. We will soon take back our separate membership of the World Trade Organisation (WTO).

When Adam Smith explained the aim of the *Wealth of Nations*, he said it was to help the government discover how it could enable its people to provide a 'plentiful subsistence' for themselves. A government could not create prosperity on its own but it could make a big difference to everyone's chances of success. The first priority is well-paid work for our own people. Not 'Britain first', but British prosperity for a reason – so that we have the capacity to be of service to others and play our part in relieving poverty and upholding peace in the world.

To say that the first priority of economic policy is domestic prosperity or full employment invites the criticism that it is a 'beggar thy neighbour' attitude. But it will not prove to be a self-serving objective, as some claim, unless it leads to persistent trading surpluses. In a system of freely floating exchange rates and low tariffs the aim should be a trade balance with the rest of the world. Our success in becoming prosperous will empower us to help others by purchasing their exports and giving aid when needed, and to play a full part internationally in upholding freedom including the rules-based trading order. We want to be independent so that we can be free and democratic, we want to be prosperous to allow a better life not just for ourselves but also to allow us to be generous in our gifts to poorer countries and diligent in helping them to progress towards the free system we have shaped and which continues to evolve.

Independence will allow us to reject the EU's self-serving protectionism. Most notably, we will be able to cut high tariffs on food, which prevent small farmers in poor countries from exporting their way out of poverty. Outside the EU we could put new urgency into programmes aimed at ending hunger through a more effective blend of aid, economic development, and trade. Whenever there is a case for international cooperation, the inclination of EU oligarchs is to use it as an excuse to demand more power for themselves. Instead, we should aim for alliances that seek the common good, such as the Commonwealth, or the economic commissions of the UN.

Within Europe there is already a working example of how the mutually respectful cooperation of independent nations can be made to work, the United Nations Economic Commission for Europe (UNECE). The Government's 'Review of the balance of competences between the EU and the UK' recognised the value of the UNECE in February 2014.[23] The UNECE is one of five UN regional commissions. It was established in 1947, is based in Geneva, and reports to the UN Economic and Social Council (ECOSOC). It is responsible for most of the technical regulation of transport, including ports, railways and roads. It also has a role in producing guidelines on pollution and in developing a global system for the labelling of chemicals. Because of its close ties with the other regional commissions, it is a far better forum for approving shared regulations than the EU. Above all, it has managed to produce many worthwhile sets of regulations without insisting that the UN must be able to exert control over the national policies of each member state.

We should encourage a new European alliance of free peoples with the motto – ever greater mutual respect. We want an orderly transition out of the EU and for the free peoples of Europe to succeed and to work closely with them. A new alliance could focus initially on security and trade, respecting the natural wish of each nation to ensure full employment for its own people, even at higher prices. Many EU member states are net recipients of EU funds that will be reduced when we leave. We should explore ways in which we can continue to invest in their development in mutually beneficial ways.

A market economy is an achievement of civilisation, not a natural growth. Economic independence gives people the power to be anchored in institutions, from the family to the various associations that make up civil society, including the legal profession, learned societies in the sciences, and independent think tanks. Inclusive capitalism requires active government, not absent government.

Compatible interventions

There are still many voices who criticise all government ‘intervention’ as such. In 2016, the leader of one free-market think tank criticised Theresa May’s industrial strategy in these terms: ‘We call on the Prime Minister to abandon her ideological attachment to interventionist economic policies, look at the evidence, and accept that it tells us that markets, not the state, are the solution to our problems.'[24]

But apologists for capitalism in its current form are undermining what is mutually beneficial about a market economy. If we want to continue adding to our prosperity we must accept that it depends on constant adaptation to fluctuating demand for goods and services through the system of voluntary exchange at freely adjusting prices. We must enjoy the personal freedom to react to incessant alteration of the conditions affecting the occupations available to us and the products we are able to buy. The mistake of free-market fundamentalists is to assume that this freedom to adapt implies minimal government. But freedom does not depend on the absence of government. As the leading influence on the 'social market' philosophy that guided the economic development of Germany after World War Two explained, a free economy is not the outcome of 'energetically doing nothing'. According to Wilhelm Röpke, it was an 'artifice of civilisation' that, like democracy, depends on all of us making the most strenuous efforts.[25] He strongly opposed laissez faire theories, which he called a kind of blundering rationalism. There was a difference between government actions that were compatible with a free economy and those that were not. Compatible actions included contract law, measures to prevent the abuse of private power through cartels and monopolies, and laws regulating corporations, including limited liability and legal personality.

Röpke was greatly admired by Hayek, whose book *The Constitution of Liberty* set out to define compatible government actions. He finished up with quite a long list. According to Hayek, freedom of economic activity 'meant freedom under the law, not the absence of government action'. He did not believe that government should 'never concern itself with any economic matters'. Many government measures were not justified because they did not work but, he said, they cannot be rejected out of hand simply because they entail 'government intervention'. They should be 'examined in each instance from the viewpoint of expediency'.[26]

Economic success depends on the freedom of people and corporations to adjust to constantly changing prices, consumer tastes, and the availability of raw materials, but recognising the necessity for free adaptation does not make it necessary to leap to the defence of whatever modern businesses do. There is a risk that, by calling valid criticisms of corporate behaviour 'business bashing' or 'banker bashing', capitalist apologists will endanger public support for the basic precepts of free enterprise on which all hope of inclusive prosperity must rest.

To succeed in world markets companies need competitive advantages. Some are the result of their own skill and inventiveness, but many are created by the government and some can only be created by the government. Here are several measures that will help us to achieve our hopes, and which are compatible with a market economy.

From 2012 the Government adopted a 'modern industrial policy' and backed eleven sectors and eight technologies.[27] They were well chosen, but it is very important that industrial strategy should not proceed as if decision makers can foresee all future developments. Room must always be left for the unexpected. The market is above all a process whereby we discover what we do not already know. It is not obvious in advance who will have the new ideas that become popular, or who will discover how to cut costs or raise standards. A primary task of government, therefore, is to create the fertile soil in which unanticipated discoveries can grow.

Suggested ‘compatible interventions’ are discussed under four headings: creating favourable conditions for enterprise; reforming banking and finance; increasing our international role in trade and defence; and tackling the ‘casino’.

CREATING FAVOURABLE DOMESTIC CONDITIONS FOR ENTERPRISE

An exchange rate that reflects the flow of imports and exports

The exchange rate has been ignored for decades, but an over-valued currency can nullify the efforts of companies to reduce prices by improving their productivity.[28] The eurozone is our biggest export market and the European Central Bank has been trying to manipulate its exchange rate downwards. After the 2016 referendum the pound fell against the euro, a move reinforced by the Bank of England’s subsequent decision to cut Bank Rate. Our Government should pursue a strategy to ensure a continuing competitive rate. We have a large trade deficit with the EU and we are entitled to ensure that the exchange rate stays low to restore balance. The IMF regularly reported for several years that the pound was over-valued, which not only put exporters at a disadvantage but weakened home producers who faced competition from importers. The IMF reported in June 2016, before the EU referendum, that the pound was over-valued by at least 12 per cent. Even after recent falls against the dollar and the euro, the pound is still over-valued.

One approach would be to widen the goals of monetary policy. The American equivalent of our Monetary Policy Committee is charged with maximising employment as well as keeping inflation low. Our policy could declare three overlapping policy goals: low inflation, maximum employment consistent with low inflation, and to prevent the exchange rate from being over-valued according to independent measures such as the World Bank's Real Effective Exchange Rate (REER). The guiding assumption should be that the exchange rate should reflect the flow of imports and exports and not the manipulations of currency speculators. Each goal is intimately related to the others, but the balanced pursuit of all three would be more consistent with the ambition to increase prosperity than the current strategy, which relies chiefly on inflation targeting.

Low-cost energy

Energy policy since 2008 has made matters worse. Mrs May has said that she wants an energy policy that 'emphasises the reliability of supply and lower costs for users'. The problem is that job creation, raising productivity and encouraging higher wages clash with carbon reduction. After the 2008 Climate Change Act, the Government's climate-change policies have added to the cost of electricity and destroyed thousands of high-paid jobs.[29] The UK Government has been repeatedly told by many business leaders that its energy policy adds to the cost of energy and puts some of our leading industries at a competitive disadvantage. The Government has been warned by the chemicals industry, ceramics, paper, steel, aluminium, cement, and others. Together they employ over 200,000 people.

The Government's strategy has been to encourage lower energy use by forcing the price above the market rate, not least by means of the carbon price floor. This policy has contributed to the decline of the steel industry, the closure of the only two aluminium smelters in England and pushed investment in chemicals outside the UK. In the latter case the policy is especially perverse because the industry makes products, such as insulating materials, that the government wants to use to improve energy efficiency.[30]

Worse still, the unilateral imposition of higher energy costs is a hidden destroyer of enterprise. Fearing higher costs in the future, companies stop investing in Britain. Major closures are reported by the media but decisions to invest overseas instead of in Britain are taken in the privacy of boardrooms. We experience the results later in low growth and fewer jobs.

It is true that Germany, our main European rival, has also adopted a costly energy policy but it compensates its industries so that they pay about half as much for electricity as British companies. There is a compensation scheme in the UK but it is too small and leaves our manufacturers at a competitive disadvantage.

Three main policies could be adopted immediately: scrap the carbon price floor; encourage fracking; and develop nuclear power by building small modular reactors (SMRs).[31]

Reform corporation tax to promote investment in productive enterprise

We urgently need to rebuild our productive capacity, and the Government could do more to encourage a surge in private investment. Corporation tax is already being lowered, but the time has come to abolish capital allowances. From 1984 capital expenditure was treated less favourably than other business costs. Until that year 100 per cent of investment in plant and machinery was a business expense that could be deducted from taxable profits, but it was replaced by a 25 per cent per year deduction on the declining-balance. Since then the system has been subject to frequent revisions and the deduction rate in 2017 was 18 per cent with a £200,000 annual allowance. A company investing, say, £500,000 can treat £200,000 as a business expense in year one, but the remaining £300,000 goes into a pool from which 18 per cent can be deducted as a business expense in each successive year. The effect is to discourage capital investment, which should be treated like any other business cost. Companies will inevitably depreciate capital spending in their accounts over a number of years, but the rate at which they do so should be their decision alone.

We should continue to lower corporation tax. At present 10 per cent is payable on profits earned on patented items under the patent box scheme. The main rate is 19 per cent in 2017 and the Government has announced its intention to go down to 17 cent by 2020. We should aim to have the lowest rate among developed countries and take the rate down in stages to 10 per cent.

Retention of existing enterprises and reshoring production

If we want everyone to share in prosperity we need industries that add value and pay good wages. There will inevitably be occasions when a company, even a whole industry, is not economically viable. In such circumstances there is no case for preserving their existence regardless of how unec0nomic they are, but when a company is struggling we should ask first whether it is because of its own failings or because government policies have made matters worse and they alone tip the competitive balance. For example, as already mentioned, energy policy has put energy-intensive sectors, including steel, ceramics and chemicals, at a disadvantage. The Government has put the steel industry in a weak position not only by imposing costs but by failing to enforce the rules of international trade. The same could be said about aluminium. Climate-change policies have already destroyed a thriving aluminium industry in England (a small factory remains in Scotland because of nearby hydro-electric power). Until recently we exported aluminium. Now we depend on imports.

The second question to ask is whether the industry is 'retainable'. The unspoken background assumption is that 'the market' will allocate capital in such a way as to winnow out high-cost producers and leave behind only the efficient ones. When this happens we are all better off. However, there is now a significant literature showing that markets do not function in that way and, in particular, do not identify the least-cost producers. A good starting point is a study by Ralph Gomory of the Alfred Sloan Foundation and Professor William Baumol of New York and Princeton Universities.[32]

Gomory and Baumol showed that, if there are economies of scale and high-start-up costs, markets entrench the position of existing producers and deter rivals. Consequently, the competitive advantage of some producers is not the result of being the most efficient producer but of having started early. When these conditions apply, industries are capable of succeeding in many locations. The list includes automobiles and steel.

In such cases, public policies should examine whether or not an industry is 'retainable'. It may or not be 'high value' but if it is profitable and retainable it is worth keeping. If an industry is 'retainable' but not currently located in the UK it is worth substantial investment to establish it in order to gain the advantages of high-entry barriers and economies of scale. For example, we should establish an independent volume car manufacturer in the UK and start making short-haul civil aircraft. Moreover, as studies based on the Atlas of Economic Complexity have shown, a nation that makes a wide range of products is in a strong position to innovate and develop new capabilities.[33]

Foreign Direct Investment (FDI)

FDI is considered a good thing, and the official statistics distinguish between portfolio investment and FDI, which is defined as a holding large enough to give some control of management. However, a holding of only 10 per cent is assumed to grant control, when it may be no more than a large portfolio stake. Moreover, some FDI is no more than a takeover of an existing company, which adds little or nothing to our economic prospects. We should aim to ensure that inward investment adds to our productive capacity. Mrs Thatcher was well aware of this distinction and supported the Invest in Britain Bureau, which promoted the kind of FDI that added to our total potential output. Japanese companies of that era, for example, brought management know-how and good industrial relations as well as money. Nissan famously revived volume car production in the UK.

Some investors are intent on extracting what they can, and will usually have an exit strategy before they buy. Even the IMF, which has promoted free movement of capital for decades, is having second thoughts. Three economists at the IMF have recently called for a more nuanced view of what economic policy can achieve and they argue for institutions like the IMF to 'be guided not by faith, but by evidence of what has worked'. Jonathan Ostry, deputy director of the IMF's research department and the article's lead author, voiced concern about two main components of economic orthodoxy: removing restrictions on capital flows across borders; and reducing fiscal deficits and national debt. These policies had not produced growth in several countries.[34]

Senior economists at the IMF have recently called for capital controls based on a distinction between 'hot money' and productive capital investment. Economic orthodoxy assumes that free movement of capital is always economically beneficial. When FDI leads to transfers of technology and know-how it may well benefit the recipient economy, but the movement of 'hot money' in and out of an economy in quick succession has been harmful. The IMF authors favour capital controls. The orthodox assumption has been that free movement of capital allows money to find its most productive outlets. But, as Chapter 3 showed, some investors are not looking for productive outlets; instead they want returns unencumbered by commitment.

If we examine countries that have successfully attracted beneficial FDI we do not need to look further afield than Ireland. For many years their Industrial Development Agency attracted inward investment that added to productive capacity. Essentially, this agency has differentiated between the private investments it wanted and those it preferred to do without.[35] The Government should scrutinise FDI to ensure that it is beneficial, as the Invest in Britain Bureau did, and as Ireland's government continues to do.[36]

Monetary Policy

The General Election of 2017 exposed the social tensions that have been deepening since the 2008 recession and the austerity measures that followed. The median wage after allowing for inflation has been flat since 2005, public sector pay restraint continues to affect doctors, teachers and nurses, and it is much harder for young people to get on the housing ladder. And yet asset prices are booming to the advantage of already-existing owners of shares, bonds and property.

Some see it as another example of the rich exploiting the poor, while others claim that one generation has 'robbed' the next.[37] But the new inequality we are living through is nothing to do with class war or inter-generational struggle, it is the result of a public policy mistake that can be corrected.

When the Government decided to introduce quantitative easing there were two possible approaches. The first would have spread the benefit more widely, either by giving each household extra cash or by funding public services such as the NHS. The second, and the one chosen by the Government, put freshly-created money into the hands of the existing owners of assets. We have all benefited to some extent. Wages would probably have been even lower and unemployment even higher without quantitative easing. But the chief beneficiaries, according to Andrew Haldane, chief economist at the Bank of England, have been owners of existing assets.[38] Real GDP per head fell in 2008-09 and not every region has recovered. In 2015 GDP per head in London was above its pre-crisis peak, but in Yorkshire and Humberside it was six per cent below. The recovery, according to Haldane, has been to a significant extent for 'those already asset rich', especially for 'those owning their own home' or with large pension pots.

Quantitative easing has relentlessly pushed up asset prices. The Bank of England's website explains why it has this effect. According to the Bank, the main transmission channel is 'portfolio rebalancing':

> 'Central bank asset purchases … push up the prices of the assets bought and also the prices of other assets… Higher asset prices mean lower yields, and lower borrowing costs for firms and households, which acts to stimulate spending. In addition, higher asset prices stimulate spending by increasing the net wealth of asset holders.'[39]

It's not too late to change direction. The alternative policy goes by the name 'helicopter money' after a statement by Milton Friedman that deficient demand could always be rapidly overcome if the government printed money and scattered it from a helicopter. A more sophisticated version has recently been advocated by Lord Turner, former chairman of the Financial Services Authority, in his 2016 book *Between Debt and the Devil*.

He points out that 'helicopter money' paid direct into all our bank accounts would give spending power to a wide range of households instead of relying on indirect transmission via higher asset prices and private credit expansion. In 2003, before becoming chairman of the federal reserve, Ben Bernanke had recommended a similar approach for Japan. Lord Turner argues that, if we had used this approach in 2008, the recession would not have been so deep and recovery would have been stronger and more equitable.

Lord Turner is aware that printing money could be used irresponsibly and that there would be a temptation to use it just before an election for party-political advantage. But just as the party-political abuse of the power to set interest rates has been defused by allocating it to an independent committee, the Monetary Policy Committee, so too could the creation of helicopter money. In any event, it is qualitatively no different from offering to raise the living wage as an election bribe, or promising to cancel all student debt.

The danger of treating voters like children who can be bribed can be reduced by spending the money, less on cash transfers to households, and more on public services that we all use. The most obvious is the NHS and social care. Funding an investment bank would be equally beneficial to everyone. It could invest in new businesses able to take advantage of the more competitive pound and produce goods for export, or to manufacture for the home market to replace more costly imports. It is widely accepted that many components for the car industry could be made in the UK instead of being imported from the Continent. The only thing holding back their development is the initial investment in new factories. Once built such factories are capable of being as efficient as any in the world.[40]

Some discussions of the monetary financing of public services see it as a choice between virtue and sin. Lord Turner convincingly argues that, compared with the monetary financing of a private asset bubble that benefits a small minority, it's the lesser evil. If the Government sails on as if nothing fundamental is happening, it will not take long to build a coalition of voters for a strategy of radical confiscation. Helicopter money is a lesser evil whose time has come.

OUR INTERNATIONAL ROLE IN TRADE AND DEFENCE

Making full use of the World Trade Organisation

We should not assume that we now face a choice between globalisation and nationalism, or between free trade and protection. The question to ask is whether international trading arrangements are mutually beneficial or whether they are leading to the one-sided aggrandisement of one nation at the expense of others, historically called mercantilism. One very simple test when looking at international trade is to ask whether the rules of the World Trade Organisation (WTO) are being followed. If not, we should take countervailing measures under the rules without fear of being labelled protectionist. We should also consider the international common good.

When we resume membership of the World Trade Organisation in our own right, we should make full use of our powers to uphold competition. As it happens its rules have been shrewdly chosen. The basic principle is that import tariffs on goods should apply equally to all other countries unless there is a regional trade agreement or a customs union. Three exceptions are accepted: dumping, subsidies, and safeguarding a domestic industry. In the latter case a government can assist a threatened industry for up to four years, extendable to eight. The underlying idea is to give a respite to a threatened industry to allow time to adjust to international competition. In the Thatcher years several sectors benefited from what could be called respite protection, including cars and steel.

Today there is a special problem of China dumping products on world markets. America makes constant use of its rights to retaliate against foreign subsidies and dumping.[41] Within WTO rules, it recently added tariffs adding up to over 500 per cent to Chinese cold-rolled steel, the kind used in car manufacture. We have given up our right to use WTO powers to the EU, but to make matters worse within the EU we have argued against making full use of our powers.

Our government has argued for applying the lowest possible duty, known as the lesser-duty rule, and has argued that other UK companies that use steel will profit from the low price of Chinese steel. This short-sighted doctrine ignores the fact that once China has eradicated rivals, it will be in a position to increase prices without constraint. Our other industries will suffer, quite apart from the fact that we will lack the means to make products for our own defence. There is a public interest in preserving our ability to compete and combat monopoly. To take no action is to uphold protectionism by China and other nations and to allow concealed subsidies to prevail over genuine competition.

At present free market utopians argue that sectors such as steel are guilty of selfish protectionism because they seek to impose high prices on many other consumers for the benefit of the few. But industries such as steel are not calling for protection from the results of their own inefficiency. They are calling for action against overseas protection. If the aim is to encourage labour and capital to find their most productive outlet, is that happening in China? The WTO has accepted that China sells overseas at below the cost of production, something it can do because its companies are largely state owned and its banks are state dominated. Moreover, there is no free bargaining for wages.[42]

This is not a fair fight to discover who is the most efficient producer of steel. And yet the Government allowed the steel plant in Redcar to close. At the eleventh hour the Government started to think differently about Port Talbot. They stopped talking as if all government interference was bad and asked what the Government could do. It turned out that one of the most damaging competitive disadvantages was created by the Government itself, the cost of energy. It also turned out that the company was able to make steel as efficiently as any other but that it could not compete with Chinese steel that was being dumped at below the cost of production. Only the Government could take action by applying the rules of the WTO.

In these circumstances to say that any intervention is 'interfering' with the efficient allocation of labour and capital ignores the most important facts. Even when the price is not a market price, but dumped, and even when the rules of international trade are broken, fundamentalists assume that the market is functioning as in the model, when it isn't.

They are the arguments of armchair economists guided by axiomatic reasoning within a closed model of the world. They are not the arguments of the activist entrepreneur who sees an array of problems that can be overcome. We need to create rules for activists not deskbound theorists who live up to the caricature in President Reagan's joke: economists are people who argue that what works in practice can't possibly work in theory.

Some commentators seem to think that taking countervailing measures against Chinese mercantilism is just another form of protectionism. But it is more accurately seen as a necessary defence of a rules-based order from which we can all benefit. Nations that ignore the rules, like China, should not gain from their wrongdoing. When nations are allowed to profit from breaking the rules we no longer have an open system in which we compete to discover which companies can best serve the consumer. Competition should be a process of learning from each other through friendly-hostile rivalry – a method by which the success of producers can be shared. It should not be an outright struggle for supremacy.

Some commentators say that job losses in America and the UK are inevitable because wages are so much lower in Asia. But, Chinese cheating also takes market share from low-wage countries. Today the real problem we face in the West is not competition from low-wage economies but mercantilism, and the challenge is how to make a reality of the rules-based order we have. That is what we should champion – not the pretence that all we need to do is eliminate barriers. It is misleading to portray free trade and protection as the only two alternatives. The top priority is to act against nations with long-standing trade surpluses that are the result of mercantilist manipulation.

The UK's policy towards China is an economic and political blunder. Mrs May has been talking about a 'golden era' for China-UK relations and has promoted investment by Chinese companies in the UK as if it were like any other inward investment. The reality is that no company in China is genuinely private. Any chief executive who fails to comply with the wishes of the Communist party will soon find the secret police calling.[43] Letting Chinese companies take over UK businesses is like letting the Chinese Government take them over. We do not want our own government to nationalise our companies, because we fear the abuse of power, and yet our government applauds when the Chinese Government takes them over. The American government has significant protections against foreign ownership,[44] and even Germany has become alarmed at the extent to which China is taking over its famous Mittelstand of high-tech world-beating companies. The German Government recently stopped the takeover of the technology company Aixtron, when it looked as if one Chinese company cancelled an order, which pushed down the share price of the German supplier, so that a second Chinese company could buy Aixtron for less. The German economics ministry has warned that in 70 per cent of the twenty largest recent takeovers, the purchasing Chinese company was majority-owned by the Chinese government.[45]

A market economy can be made to serve the ends of an authoritarian dictatorship, as China's communists have revealed. In China wealth creation bolsters the power of the Communist party. It does not create strong independent organisations that can prevent governments from abusing the powers at their disposal. The aim of a free society is to prevent the concentration of power in a few hands. China aims for the exact opposite. It does not even make a pretence of being democratic. Russia holds elections and has a constitution that reads like that of a liberal democracy, but is in practice a dictatorship. The liberals of the 1930s had a realistic fear that even more free societies would submit to authoritarian collectivism, as Italy, Germany and Spain had done. Today that danger is not so great, but China and Russia offer rival authoritarian models of state capitalism for nations to emulate.

Ensuring that takeovers are in the international public interest

Mergers and acquisitions are not necessarily beneficial, even for shareholders. For example, a good case can be made for preventing foreign investment when a foreign company plans to take over a domestic rival, close it down, and thereby reduce competition. There have been beneficial foreign takeovers in recent years. The takeover of Jaguar Land Rover by Tata, for example, has been followed by significant new investment in the company. In other cases, the motive of investors was to weaken competition from a British rival or to strengthen monopoly. For example, the French company Alstom took over British train builder Metro-Cammell in 1989, completed its main contract, and shut the factory in 2005.

Some critics say that the national interest can't be defined and fear that the Government is about to adopt 'nativist protectionism'. But the issue is not about nationality as such. Proposed foreign takeovers should all be referred to a competition regulator to ensure that the outcome will not reduce worldwide competition. Until the 2002 Enterprise Act the Secretary of State could intervene to prevent actions detrimental to the interests of consumers. This general 'public interest' test should never have been abolished and should be reinstated.

As guardian of our own national interest and the international community's public interest, Parliament is entitled to ask whether or not specific investments are likely to increase or reduce competition. And it is entitled to ask whether sectors should be declared of strategic importance and protected from foreign takeover. We should be especially wary of allowing foreign governments to buy companies. Our ability to defend freedom and democracy throughout the world could be compromised, a danger that applies especially to takeovers by authoritarian regimes such as China.

Defence spending

We should signal to the world that we are committed to full international engagement by increasing defence spending to well above two per cent of GDP. The world has become more dangerous recently and we should play our part in resisting the new threats. As an essential part of this strategy we should increase our defence-industrial capacity. It would make us both safer and generate high-skill, well-paid jobs.

REFORMING BANKING AND FINANCE

Renewal of cities: localising investment power

Rebuilding productive capacity in places such as Hartlepool, Middlesbrough, Sunderland and Newcastle upon Tyne cannot be achieved solely by allocating funds from a central budget. The primary objective should be to empower people who live locally to solve their own problems by restoring investment power to localities. Each area should have its own deposit-taking bank that can only lend locally. In addition, in order to encourage closer ties between councils and local businesses, and to promote civic enterprise, councils could be given the power to co-opt local business leaders, who could take part in decision making but without the power to vote (which should be confined to elected representatives).

German local savings banks (Sparkassen) hold about 40 per cent of all customer deposits and provide about 40 per cent of all business loans. Sparkassen typically operate within the boundaries of a local council and can't lend outside. During the 2008 recession they increased loans to business while the big international banks cut them. Losses are relatively low because customers are known by reputation. The significance of local relationship banks is that people throughout the land have the power to make a difference, instead of pleading for loans from London-based banks.

The USA also has numerous local banks that operate on similar lines to the Sparkassen, often confined to a federal state. In the UK, we used to have similar institutions until the TSB was privatised in the 1980s. One bank, the Airdrie Savings Bank, stayed outside the TSB group and still exists today. It has eight branches and 60,000 customers. Eighty per cent of its loans go to local businesses; and 35 per cent are for five years or more. Good local knowledge has kept losses down, and under two per cent of total lending was written off in 2010. Like the Sparkassen, the Airdrie Savings Bank increased lending during the recent crisis. Loans were up from £28m in 2006 to £36m in 2010. Local banks have the potential to transform local economic prospects and would emerge with only a little encouragement from the Government.[46]

Establish a British Infrastructure Bank

The Government has established the British Business Bank. It began with £3.9bn of funding, although £2.9bn of this came from existing commitments now transferred to the administration of the Business Bank, including Capital for

Enterprise Ltd. All existing government finance schemes were brought together in one place.[47] The British Business Bank, however, does not directly lend to firms or invest in them, and that is what is needed.

This objective could be met if the Government sold bonds solely to fund a 'British Infrastructure Bank'. Such 'infrastructure bonds' could be purchased by anyone with a British residential address to finance a new wave of investment in road, rail, housing, ports, energy generation, manufacturing capacity, and the internet. One approach would be to sell convertible bonds like those recently introduced by Toyota. After five years, investors in Toyota can sell the bonds back to the company at the issue price, or convert them to ordinary stock. In the first year they receive a low rate of interest which gradually rises to 2.5 per cent after five years. Following this model, UK infrastructure bonds could pay 1.5 per cent in the first year, rising to 2.5 per cent in year five, at which point they could be redeemed at face value or converted to dividend-earning shares in the British Infrastructure Bank.

The British Infrastructure Bank should be permitted to invest directly in private enterprise. The usual model for an industry bank is the Industrial and Commercial Finance Corporation (ICFC), which was founded by the Bank of England and the major British banks in 1945 to provide long-term investment for small and medium-sized enterprises. During the 1950s and 1960s it became the largest provider of capital for unquoted companies in the United Kingdom.[48]

TACKLING THE 'CASINO'

The legal status of corporations

We saw earlier that University of Chicago economist Henry Simons argued that America might have been better off without the business corporation. It may seem surprising that Hayek was also sceptical of them. He argued that the tendency of business corporations to 'develop into self-willed and possibly irresponsible empires, aggregates of enormous and largely uncontrollable power, is not a fact which we must accept as inevitable'. He went on to argue that corporations were 'largely the result of special conditions which the law has created and the law can change'. Limited liability, for instance is a privilege and it is for the law to decide 'on which conditions this privilege is to be granted'.[49]

Like all the genuinely liberal economists from Adam Smith onwards he was no apologist for big business and saw clearly some of the dangers of the current structure of corporations. The basic insight behind support for a market economy is that if people are allowed to exercise personal responsibility at their own risk, resources are more likely to be put to their most beneficial use. At its simplest a market economy is a system of accommodating many people's interests through mutually acceptable bargains.

But that does not mean that the institutions for large-scale business created by our laws have evolved to their best form. Limited liability allows shareholders to risk only the amount invested, not every penny they own, and incorporation gives companies a legal status that allows them to be pursued in the courts if need be.

Hayek, along with others, proposed that all shareholders should have an annual opportunity to decide whether their personal share of the net profit should be ploughed back or taken as income.[50] At present the majority make that decision on the advice of management, but it is very easy for companies to fall into the hands of people who do not have the interests of all shareholders at heart. An annual vote would force them to consider the interests of all. In recent years governments have spoken favourably about shareholder democracy, chiefly in connection with votes on executive remuneration. An annual choice on the distribution of profits would be potentially far more transformative.

Limited liability

We think of limited liability as a normal feature of a company, but it is a legal privilege that was for many years strongly resisted, especially by defenders of individual freedom. Parliament set up a select committee in 1850 to investigate its introduction and it recommended against. However, the Limited Liability Act was passed in 1855 and reaffirmed by the Joint Stock Companies Act of 1856. The 1855 Act gave limited liability to any company of 25 or more members (shareholders) except in insurance or banking. The 1856 Act extended it to any company with seven or more members and required them to add the word 'limited' to their name.[51]

In 1858 it was extended to joint-stock banks. Some banks with unlimited liabilities had collapsed in 1857 in Scotland and it was argued that the risk of failure would be reduced. However, the biggest bank collapse ever occurred in 1866, when Overend, Gurney Limited failed, leading to several other collapses.[52] In 1862 limited liability was extended to insurance, although it was already included in many insurance contracts.

Opponents argued that the 'limitation of responsibility' was a recipe for fraud and recklessness. *The Times* newspaper was strongly opposed. It strongly resisted extending limited liability to banks in the 1830s: 'If any person imagined that he could have all the gains of a trade (for banking is a trade) without incurring any chance of its losses, he ought to write "fool" after his name in the list of subscribers.'[53]

J.R. McCulloch was one of the outstanding classical economists of his generation. He was the first professor of political economy at University College London, and a founder as well as one of the early editors, of the *Scotsman* newspaper. He edited the 1828 edition of Adam Smith's *The Wealth of Nations*. He never trusted 'limitation of responsibility'. If Parliament 'set about devising means for the encouragement of speculation, overtrading and swindling what better could it do?', asked McCulloch.[54]

In an article in *Encyclopaedia Britannica* he wrote:

> 'in the scheme laid down by Providence for the government of the world there is no shifting or narrowing of responsibilities, every man being personally answerable for his actions. But the advocates of limited responsibility proclaim … that debts and obligations may be contracted which the debtors though they have the means, shall not be bound to discharge.'[55]

We should ask whether all business activity is equally deserving of the legal privilege of limited liability. Sole proprietors do not have limited liability, nor do partners in traditional partnerships.[56] A case can be made that investment in productive enterprise merits limited liability, but does pure arbitrage deserve special protection? When is trading in stocks and shares different from gambling? Taking bets on whether a share will go up or down in price does not deserve the same protection as investing in an asset such as a factory or an office block in the expectation that it will produce an income. The case for limited liability was based on the desirability of encouraging investment in new enterprises, but do we really want to encourage arbitrage? The alternative to granting limited liability is not prohibition. It is merely to expect its practitioners to take full responsibility for all losses.

In the wake of the 2008 recession Professor Kotlikoff of Boston University defended the withdrawal of limited liability from 'casino' banking. His aim was to confine banks to their legitimate purpose, namely connecting lenders to borrowers and savers to investors but without gambling. In *The Economic Consequences of the Vickers Commission* he concluded that banks should function more like mutual funds.[57] Modern mutual funds have been functioning successfully for several decades in America and many people in the UK will be familiar with organisations like Fidelity and Vanguard. The essential feature of mutual funds that Professor Kotlikoff wished to harness was that individual investors could gamble knowingly with their own money, whereas the mutual fund itself should not gamble with customers' cash. An individual can, for example, invest £1,000 in an index fund that tracks the Japanese stock market. The investor hopes the index will go up, but takes the risk that it will go down. The mutual fund in this case is only an intermediary that receives money from investors and buys Japanese stocks. It is not supposed to use the money for any other purpose, let alone gamble it on high-risk derivatives. And yet our high-street banks have often taken customers deposits and invested them in extraordinarily risky instruments while customers believed their money was in safe hands.

Narrow-purpose banking does not try to eliminate risk, or even prevent people from taking the most extreme gambles. It says only that they must do so with their own money and at their own risk. And above all, no third party such as the government will come to their rescue. Risks are fine but not with other people's money, unless you tell them first.

Under Kotlikoff's scheme, bank current accounts would become cash mutual funds, literally holding nothing but cash, effectively a system of 100 per cent reserve banking for demand deposits. Customers would write cheques, make payments by debit card, use mobile phone apps or withdraw cash as normal. Other functions of the financial services industry, including insurance, would also be carried out by mutual funds. But high-risk investment banking should be conducted at the sole risk of the investors who would not have limited liability.

To sum up: Kotlikoff and others who share his view do not wish to prohibit people from engaging in high-stakes activity, they only insist that they must do so completely at their own risk. Kotlikoff attaches special important to US-style mutual funds but under UK law the simplest approach would be to require some business activity to be carried out with the legal status of either a sole proprietor or a partnership with unlimited liability.

5

Conclusions

We are taking back our independence at a time when some of the unspoken assumptions of recent times are shifting. To speak of the political left or the political right no longer has a clear meaning. To argue that we should have a market economy and not a command-and-control economy is common ground between the main political parties, though Labour would make rather more vigorous use of the powers of the state. Some say that the real divide is between globalisation and nationalism, but this distinction fails to capture what is really at stake, namely the accountability of political power.

Globalisation has taken two main forms: economic and legal. Economic globalisation is based on an abstract model of the economy, which like the EU, insists on 'four freedoms': freedom of movement for goods, services, capital and labour. They are not really 'freedoms'; they are the axioms of laissez faire economics. Goods and services are forms of merchandise produced to be bought and sold, but money is not a pure commodity and people are certainly not a form of merchandise. This narrow, stunted view of the human condition aspires to create international organisations to enforce its doctrines. Determined attempts were made to turn the WTO into the enforcer but have so far failed. NAFTA incorporates many of the features that make globalisation attractive to international corporations, namely investor-state dispute settlement (ISDS), which allows companies to override the laws made by national democracies. National protections for health or safety are treated as non-tariff barriers, when they are legitimate democratic actions.

Demands for legal globalisation prefer to be seen as calls for 'human rights'. On the surface it may seem that campaigns for global human rights are very different, but they derive from the same kind of abstract reasoning and a hollowed-out view of the individual. Humans are abstract units with rights to be enforced by international bodies.

The main rival to both these universalistic ideologies is the nation state. Why? Because it is the place where power can be effectively held to account. Moreover, national democracy allows each free people to work out its own salvation. For the international corporation the problem is that nations might make some laws they do not like, which is why they advocate dispute settlement procedures that allow them to override national democracies.

Theirs is the same as the mindset of human rights activists who want international courts to be able to overrule national governments. Nations, however, must be based on mutual respect and reciprocity between the main groups comprising society. In finding mutual accommodations they might make decisions disliked by human rights activists, which is why they demand the power of veto.

The ultimate aim in both cases is world government. The small groups who aspire to world government expect that they will be in charge and so are not worried about the removability and accountability of power holders in global institutions. But as Immanuel Kant, one of the great philosophers of the Enlightenment, pointed out, a system of world rule would put power holders above the law and beyond control.[1]

The challenge today is not to choose between the left and the right, the market and the state, open or closed societies, or free trade and protection. Rather, it is to decide whether we want the overwhelming concentration of unaccountable power, or dispersed and accountable power in national democracies in which rulers are temporary office holders who act as trustees for the people themselves.

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The UK is taking back its independence at a time when some of the unspoken assumptions of recent times are shifting. To speak of the political left or the political right no longer has a clear meaning. Some say that the real divide is between globalisation and nationalism, but this distinction fails to capture what is really at stake, namely the accountability of political power.

In this new book, David G. Green argues that the challenge today is not to choose between the left and the right, the market and the state, open or closed societies, or free trade and protection. Rather, it is to decide whether we want the overwhelming concentration of unaccountable power, or dispersed and accountable power in national democracies in which rulers are temporary office holders who act as trustees for the people themselves.

The main threat to the success of Brexit therefore is that the government will be paralysed by the economic ideology of market fundamentalism. This system of beliefs regards government as always and everywhere the enemy of freedom, and our economic life as a set of axiomatic relationships that can be understood only with the special insight of economists. The 'four freedoms' of the EU – the freedom of movement for goods, services, capital and labour – are based on this ideology. They are really the four shibboleths of market fundamentalism.

Brexit provides the UK with an opportunity to break free of market fundamentalism and to embrace a new Inclusive Capitalism – an economic and political system compatible with democracy, personal freedom, international peace, and a market economy that is inclusive rather than extractive. This system recognises that a market economy is not a natural outcome found in the absence of intervention by the state. Rather, it is an achievement of legislation and public policy. We need continuously to refine the laws and institutions of business and commerce.

"Soon our future will be back in our own hands. Our journey to independence gives us the chance to renew our vows as a free people and to look afresh at the problems we face and the opportunities we could seize. Whether we succeed or fail will depend in part on the public policies we pursue, especially those that have the potential to impair or enhance our spirit of enterprise. This book is a contribution to the debate about how we can make the most of Brexit. What economic policies are most likely to lead to prosperity for all, and what are the pitfalls to avoid?"

David G. Green

ISBN 978-1-906837-92-1

978-1-906837-92-1

£6